

International Forum on "The Micro Foundations of East Asian Economic Integration"

February 27, 2007

1. Opening

Masahiro Kuroda: There was a session yesterday at the research Institute. Today we want to discuss the road for Japan in the East Asian region going forward. One possible collaboration is to focus on revitalizing trade and the economy.

Peter Drysdale: Over the last year we have looked at the issues now confronting policymakers in East Asia in their challenges in promoting economic integration with in the region on a stable and equitable basis. Of course, economic integration, the growth of trade and investment relations between our economies, is not an object in itself. The important interest is in building a basis for prosperity and stability within the region, and that includes managing economic integration, increased trade and investment and other business activities that bring the economies of the region successfully together.

In this regard, what we have been doing is looking at challenges for national policymaking and national policymakers in promoting their interests in effective international integration focused increasingly on the region because of the growth of trade and investment and other relations among the economies of the region. We have been focusing on the way in which those national policies spillover into the interests of other economies in the region collectively and promoting a case for cooperation in policymaking. We looked at the way in which arrangements in the past within East Asia and across the Pacific such as APEC have promoted that process. We have looked at the regional arrangements in more recent times, especially since the East Asian financial crisis, the ASEAN + 3 process, and are seeking to promote those interests.

Our agenda is to try and define a way forward that promotes those interests that may be of use to policymakers, especially in the dimension of the policy focus on regional cooperation. There are particular interests in mind in that respect and we can keep those in the backs of our mind as we have panel discussions this morning. We have an East Asian summit process, and ASEAN + 3 process, and APEC process. We are looking ahead at how the agenda will evolve in regional cooperation over the next several years. It is on those topics that we will focus today.

The first conclusion that comes out of our work over the last nine months, and this is the set of issues that will be taken up in the first panel, is that the region is moving from what has been called "the first generation of economic reform upon which East Asian integration has been built." Those reforms can be characterized as having focused on the barriers to developing relations among our economies at the border. Trade liberalization, opening of trade (not the complete opening of trade as you know, we still have a long way to go on agendas for free of trade in several dimensions as we will discuss today). There has been considerable success in the liberalization of our economies in East Asia and they are in some sense a model for the first generation of economic reforms.

Now, however, our economies are confronted by what might be thought of as second-generation economic reforms, which the panelists will talk about that in the first section. These challenges focus on issues behind the border, regulatory institutions and other systems that inhibit business between our economies because of regulatory and institutional systems that are entrenched in national policymaking processes. The second generation of reforms that promote regional economic integration will importantly revolve around those sorts of barriers to doing business more intensively among the East Asian and Pacific economies.

2. Significance of Economic Integration in the Asia Pacific Region

Masahiro Kuroda: Our research has investigated the necessary elements and the significance of economic integration in East Asia and the Pacific.

Philippa Dee: The East Asian region has already achieved a remarkable degree of integration and I think it is fair to say that has been mostly market-driven. It has been helped by the opening of the markets to allow the free flow of trade and investment. As Prof. Drysdale said, it may be time to shift the focus to behind-the-border measures.

There are two reasons for that. The first is that it is very important to ensure that we are safeguarding competition generally in our economies, not just protecting particular competitors. It is also very important to make sure that we have appropriate regulations in place in areas where productivity is very important and where the market alone may not produce the best outcomes. This is in areas such as infrastructure, services for example.

The shift in policy focus also involves a shift in political arenas. We would be moving away from a trade negotiating mode of operation towards one focused on the domestic political arena. This poses a great challenge for mechanisms of regional cooperation. The challenge is how to think of ways of giving regional

assistance and ways of promoting regional cooperation that can help in a domestic political arena without appearing intrusive.

To help understand and meet this challenge we have been working with colleagues from around the region for the last 12 months, essentially trying to deconstruct the domestic political policymaking process to try to find some of the principles of good domestic policymaking. We think some of those principles involve the following:

The first is an economy-wide view, making sure that all interests are taken into account, not just particular vested interests. This involves taking into account costs and benefits, not just in the particular part of the economy that is under focus but also taking into account impacts on industries upstream or downstream from the particular area of focus, taking into account the interests of consumers as well as producers, governments as well as the private sector.

The second principle is transparency. This involves making sure that policymaking process are open and public so that all interests can be heard in a public way. The processes by which the various interests are balanced against each other is also made clear to everybody.

The third principle is independent reviews of policy and policy options that embody the first two principles: independent reviews that take an economy-wide view, that take all interests into account in an open and transparent way, and using those reviews as a mechanism firstly to evaluate the performance of current policy settings and then to think a better policy options as circumstances change.

My colleagues will deconstruct the process of policymaking in their own economies so that you will see how some of these principles have been manifested in policymaking processes and you will hear their experience about what has worked and what happened and why.

As to the question of how regional cooperation can assist domestic governments, there are a number of possibilities that we can list in the second panel. Some include: things as simple as sharing experience about domestic policymaking processes. This is where we will begin this morning. There are other options that might involve particular countries self-selecting for further assistance in a way that does not involve compunction about where they volunteer themselves. That assistance may involve things such as helping them undertake policy reviews that can then feed in to the domestic policymaking process without prejudging the outcome of that process.

Masahiro Kuroda: The challenge for the first generation was economic integration, but now we are the second generation and this entails domestic competition policies as well as infrastructure for competition. How can these be

developed in order to realize competition in the region? How to achieve harmonization among the countries that take part in this economy? The challenges for economic integration in the second generation, as summarized by Dr. Dee, must follow several sets of principles. Based on these principles, the countries in this region must pursue cooperation.

Josef Yap: I will not comment directly about the Filipino case. Rather I will present a framework that is an extension of what Professor Dee earlier talked about.

My first line contains the standard justification for domestic regulation. They relate to market failure. For economic regulation, the justification is usually monopoly, where the response of regulation is to set prices, profit and entry. In the case of social regulation, there may be a situation of imperfect information externalities, so regulation imposes pollution control or product standards.

However regulation can cause distortion by imposing unnecessary costs and unjust distribution of wealth. There is also international distortions in the form of discrimination against foreign products, barring foreign firms from entry etc. which lead to economic domestic inefficiency.

The response to these distortions is regulatory reform. The key elements are competition policy and procedural requirements such as mandatory cost benefit analysis. The criteria to satisfy here should be that they are economy-wide, transparent and submit to regular policy reviews.

What I would like to emphasize is the internationalization of the reform process. This forms the link in the domestic regulatory reform and regional/global economic integration and cooperation. Normally, the internationalization of reform will involve an agenda. For example, you have the issue of national treatment of a harmonization of standards and equal tax rates. If you look at it from this perspective, it is usually how domestic regulation and regulatory reform will promote economic integration and economic cooperation.

However, internationalization also calls a feedback mechanism. How economic integration and cooperation can affect and accelerate the pace of domestic regulation and regulatory reform. The basic factor is that internationalization provides additional leverage to policymakers. When they try to institute reform, they are able to cite as a reason their commitments to international fora or treaties. Internationalization also provides broader attention and participation, which reduces the influence of narrow vested interests. Internationalization exposes policymakers to best practices, which allows them to formulate a blueprint that they can easily show to the various stakeholders in order to convince them of the viability of the reform process. Internationalization also

entails mutuality in regulatory reform. Both domestic and international participants must be able to benefit from regulatory reform. Of course, internationalization enables policymakers to lock in previous reforms that they have already instituted.

However, there are challenges and constraints to internationalization. The first is that the large disparity in economic development in the region may prevent some countries from being able to take advantage of the opportunities provided by globalization and regional integration. Some bilateral or even regional cooperation movements address this. For example, the Japan-Philippine Economic Partnership Agreement contains provisions for assistance and cooperation. There is also the problem of political and cultural diversity, which may hamper the development of regional institutions that can promote closer economic cooperation and integration. You also have the nationalist argument that sovereignty is threatened.

Given this context, the issue is what is the optimal regional grouping? Is it ASEAN, is it ASEAN + 3, APEC, WTO? How can we address the large disparity in economic development, political and cultural diversity and the nationalist argument?

In my paper I say: Different criteria may yield different answers in identifying the optimal regional grouping. For example, if the issue is the perception of foreign interference, ASEAN can be fanned out as a paragon institution since its leaders are very careful about the issue of sovereignty. However, this limits the effectiveness of ASEAN because of the principle of consensus in decision-making, which is consistent with respecting sovereignty. In the case of APEC, it can also be considered a voluntary organization, so it is not very intrusive. However, this limits the effectiveness of APEC because of nonbinding commitments. If the primary concern is narrowing the development divide, APEC has the advantage of having a wider spectrum of best practices to choose from. However, the cooperation within APEC is constrained by the number and geographical distance of the countries involved. A useful compromise may actually be ASEAN + 6, which includes Japan, China, Australia and New Zealand. This lends itself to greater political social cohesion. However, this discussion avoids providing descriptions.

Masahiro Kuroda: These have been valuable suggestions. In the first generation, competition policy and domestic policy are important. International harmonization will be the key issue leading to the second generation of economic reform. In trying to move forward with such policies, there can be several options. One thing is that amongst the countries with different economic stages of development, it will be difficult to try to harmonize the process. This is one challenge. Secondly, the differences in economic

development stages are also differences in political regimes as well as economic and social regimes. What are the constraints? Depending on all these conditions, the options or the pathway toward integration may vary. This is what Dr. Yap just suggested.

He Fan: I hope to explain why behind-the-border reform is very important and the internationalization of this kind of reform is very important.

At first glance, you may see the Chinese economy as quite rosy. The growth rate is about 10% and inflation is very low. I am quite confident that in the coming one or two years we can still maintain very high economic growth, but that does not mean we do not have problems. Actually, we have a lot of serious problems. The major challenges for macroeconomic policy are the internal and external imbalances.

By internal imbalance, we have excessively high savings rates. The savings rate in China is maybe one of the highest in the world. Why so our households in China save so much? One reason is because we do not have a well functioning social safety network. People have to save more for their retirement, their unemployment, their health care, their education. This is called precautionary savings. Excessively high precautionary savings have some very negative impacts on the Chinese economy because very high savings rates mean domestic consumption is not very strong, which means we have to rely on the foreign markets for China's economic growth. This is becoming more and more difficult.

By external imbalance I mean we have twin surpluses in the current account and capital account. It is easy to understand the current account surplus because we have a higher savings and investment, which means we have to export more to foreign countries, and this is a typical phenomenon for other countries in East Asia. The question is why China also has a capital account surplus. Chinese people are poor, but we do not lack money because we have a high savings rate. Why do we need so much foreign direct investment, so much capital inflow? One reason is that we do not have a well functioning domestic financial system. The domestic banking system and financial system do not play the role of transferring domestic savings to domestic investment. This is created a very strange phenomenon called "round tripping." It is actually Chinese capital that flows out and then comes back disguised as foreign capital to take advantage of the preferential policy provided to foreign direct investments and enjoy some other privileges like better protection of property rights and better treatment, better prices for land, better prices for workers. This kind of round tripping is a distortion of asset allocation.

In order to solve all these macro balances we have to speed up the structural reform. We have to rebuild a nationwide social safety net work and speed up

the reform of the banking system and invest more for human capital, for public education and public health. Even if China's GDP growth rate is very high, the public investment in health and education lag behind the growth rate of GDP. This has a very dangerous implication for the future economic growth of China. If we cannot solve these problems, we will lose the momentum in the future for hyper economic growth.

In some sense, China's experience may be unique, but the Chinese story is not totally different from other countries in this region. In this region we have many similar problems that we are facing. For example, I am quite sympathetic to know that in Japan the productivity of the service sector is way below that of the manufacturing sector because in China we have the same problem. I am trying very hard to understand the opening up of the financial system in Korea because in China we are in the same situation. I have kept a close eye on the turmoil in Thailand because a lot of Chinese scholars fear that the next target will be China. We have the same problem of a large amount of capital inflow and we are worried that this may reverse and we will have trouble. I think this background helps us to better understand why the second-generation reform, the behind-the-border reform in this region, is very important. We already have the FTA, trade issues, the Chiang Mai initiative for monetary integration. APEC has laid an ideal platform for countries in this region to carry on this very important structural reform.

Masahiro Kuroda: It has learned from the experiences of other countries in this region and is ready to pursue further integration.

Naohiro Yashiro: As Prof. Drysdale mentioned that the outset, the first generation of integration was market oriented, but we are now proceeding to the second-generation whereby respective countries are making efforts to develop infrastructure. There are many reasons why these must be pursued.

One reason is the speed of the aging of our societies. The three lines on top of the figure all show the situation in Japan and indicate that Japan's demographic aging is accelerating. China and other East Asian countries will also age at similar speeds in the future. Aging demographics mean that institutions and structures that were built when there were lots of young people must be quickly changed, but it also means that there is a lot of resistance to the change.

Japan also experienced a period when it had more than 10% economic growth. And then we fell to the 4% percent range and since the 1990s economic growth has been hovering at 1 or 2%. Under the Abe administration, a new growth strategy has been formulated to break out of prolonged stagnation and realize new growth. One point in this new growth strategy is the pursuit of information technology. Up until now, Japan has been very strong in terms of

creating IT technology per se, but its real usage compared to other countries has lagged behind. There was therefore an imbalance in IT in Japan, especially in the service sector. One crucial question going forward for Japan will be how to utilize information technologies. Tonight we will be having a discussion in the Council on Economic and Fiscal Policy that will focus on structural reform in academia from the perspective of IT.

The second issue is openness. APEC is one such pillar in Japan's efforts to open up.

The third issue would be deregulation. We need structural reform. This is particularly true when it comes to the health industry, which will be a growth industry as society ages. There is still strong potential for this industry going forward and the government needs to pursue deregulation so that the sector is even more productive in the future.

Last, we need structural reform in the labor market. The aging population means that the population is decreasing. We look to the next five years and we see accelerating declines in labor. This requires further productivity growth if it is to be overcome. In Japan, manufacturing achieves extra high levels of productivity, but the service sector is extremely low. Our aggregate level of productivity is therefore low. This also means that we have a latent asset in that if structural reform policies can concentrate on the lowest productivity sectors, there is still room and potential for further growth in productivity. To do that, we must make even more effective IT investments.

One key would be foreign direct investment. Outgoing FDI has been growing very well, but incoming FDI, while increasing, is still low and there is a large gap between incoming and outgoing. We need to reform so that our markets are attractive to foreign investors, and in particular we need to reform the labor market. We are looking at the impact of a labor market Big Bang in the context of structural reform. Valuable human resources must be utilized in the most efficient manner to further improve productivity.

To do that, in the context of APEC, we need to pursue collaboration with different countries and utilizing peer pressure of a sort to say that since other countries are doing so well and working so hard Japan last make equal efforts.

Masahiro Kuroda: At this moment, the biggest problem faced by Japan is the aging of society and a decline in our population. We are trying to bring about regulatory form to improve productivity and economic integration is an important part of this process.

Peter Drysdale: What are we talking about the second-generation reforms? It is quite clear when you look at the experiences of China and Japan that there are going to be significant differences across countries on the priorities attached to

these reforms. There will be a great deal of diversity in the interest in pursuing second-generation reforms among countries in our region. That raises a question in my mind about how we can comprehend this diversity in the approach to second-generation reforms. In the first generation, it may have been a simple matter of liberalizing trade at the border, reducing tariffs, and making commitments to other economies in the region. But now we face a whole range of interests and opportunities and, importantly, a whole range of priorities in confronting the second-generation reform issues. That is my second point. At the beginning of the panel Dr. Dee identified three principles that were important in improving second-generation reform. These principles were developing an economy-wide focus in the process of policy development, encouraging transparency in the policymaking process so there is full consideration of all the issues and effects of policies when they are developed. The third principle is the principle of independent assessment of policy impact and performance. How to apply these principles in different circumstances and different economies? How can they be used to improve the policy process, enhance competitiveness and productivity and the strength of integration within the regional economies? I would like to hear from all of the panelists on these issues.

Philippa Dee: Certainly, there is a diversity of policy priorities. My sense is that many countries are well aware of their own domestic policy problems. They have no difficulty identifying problems. They may have difficulty implementing reforms in the face of sometimes quite strong resistance from particular segments of their domestic economy. So I think we can comprehend diversity by letting each economy choose its own priority areas but giving assistance in the policymaking process. How the principles of economy-wide view, transparency and independence apply to that instance is that they apply to the policy process, not to any particular policy priority. It is a focus on process rather than a focus on particular areas of reform.

Josef Yap: In the case of the Philippines, we had a head start in identifying appropriate policies to implement, but what is making it difficult to implement these policies, particularly in regulatory reform, is the stranglehold of the elitist structure in our economy. Compared to other economies in Southeast Asia and East Asia, we have an entrenched elitist structure that has a longer history and a stronger hold on the economy. One example is a study comparing bureaucracies across Southeast Asia. Countries in East Asia generally use meritocracy in running their bureaucracies, but the Philippines has very prevalent patronage politics and this really affects the pace and effectiveness of reform.

He Fan: It is true that each country has its priorities, but I think that in an era of globalization it is not difficult to find issues that countries in this region have in common. One big issue is global imbalance. Many countries in this region have similar challenges and pressures for currency appreciation and the challenge of how to manage the accumulation of foreign exchange reserves. This issue could result in more mutual understanding and dialogue and maybe collective action in this region. Second, in the financial system, countries like Japan, Korea and China and a lot of Southeast Asian countries share similarities, for example the banking system takes the lion's share while bond markets are underdeveloped. This is also a field that we need to further cooperate on. There are some emerging issues like energy because the whole region is becoming a net importer of oil and other well materials and this has increased the vulnerability of our economies. I think there is plenty of room for cooperation on this issue. Environment is another issue, which is becoming global or regional in nature. The pollution in one country may spill over to another. It is a negative externality. This clearly one area that the countries in this region should work on.

Naohiro Yashiro: In addition to the APEC integration, Japan is also negotiating an FTA with Australia. Negotiations have just started, but it is of critical importance to Japan because Australia is a major agricultural producing country, whereas Japan's agriculture is quite weak. If we were to open the market right now, Australian agricultural companies would dominate in the domestic market. I think this is a very good challenge for Japanese policymaking. In the old days, we had the same experience because we set targets for liberalization of the automobile industry vis a vis very strong US car makers. We set targets and achieved them. The automotive industry has flourished. The same thing may happen in agriculture. Why cannot our agriculture compete? We have plenty of land and a warm climate. We have abundant water resources. It is entirely the failure of agriculture policy that has kept Japan's agriculture so weak in international competitiveness. If we change the policy to a more appropriate way, it is not impossible to improve agricultural productivity. We can even export our agricultural products to Australia.

Masahiro Kuroda: We have been able to talk about some of the issues involved in the realization of the second-generation reforms and I think this can be reflected in our next session as well.

3. Challenges for East Asian and Pacific Regional Integration

Peter Drysdale: Our focus in this panel will be on what opportunities there may be to make progress through regional cooperation in second-generation reform and in enhancing the scope for regional integration.

Kyung Tae Lee: FTAs put sovereign states under greater pressure to pursue structural reform to improve domestic competitiveness. FTAs have long supported multilateral trading system because the progress in the ongoing WTO negotiations is very slow and they are very rapid expansion of free trade agreements in other parts of the world. The bilateral free-trade agreements between Asia-Pacific and East Asian countries reinforce the progress of trade liberalization and also promote more domestic structural reform in the countries out of the region.

On the other hand, it seems that there are too many bilateral FTAs between Asia-Pacific countries and this poses the risk of fragmenting the regional economy. To address this risk, we need a region-wide free-trade agreement in the Asia-Pacific or in East Asia. The East Asia free-trade agreement has long been discussed ever since the Asian financial crisis 10 years ago. There are many reasons for and East Asia FTA, the most fundamental of which is to realize our long-term vision of building an East Asian community. In terms of long-term perspectives, the East Asian community will be similar to the European Community. In parallel with the idea of an East Asian free-trade agreement there is a new initiative to pursue a free-trade agreement of the Asia-Pacific region. Last year, the APEC leaders agreed to undertake further studies on ways and means to promote regional economic integration, including a free-trade area of the Asia-Pacific as a long-term prospect.

The question is between the East Asian FTA and the Asia-Pacific FTA, what should come earlier? In my view, we had better start with the East Asian FTA and then expand into a bigger integration which is the free-trade area of Asia-Pacific. As I mentioned already, the East Asian FTA has been studied for almost a decade. On the other hand, the free-trade agreement of Asia-Pacific is relatively new as an idea.

There are two key issues in an East Asian FTA. One is membership; the other, timing. The membership issue has two competing ideas. One is that ASEAN + 3 countries should participate; the other, that ASEAN + 6 countries should participate. As was mentioned in the previous session, ASEAN + 6 means the 3 plus Australia, New Zealand and India. In my view, the answer to that question is whether or not the inclusion of Australia, New Zealand and India will make real negotiations more difficult. If not, I think we can start from ASEAN + 6 countries.

About the timing issue, I think we should start the negotiation in 2010. It is an ideal year. In that year, Japan hosts the APEC leaders meeting and maybe exert leadership in convincing member countries to launch negotiations on the FTA. Of course, there are many challenges for an East Asian FTA or free-trade area of Asia-Pacific, but with strong political will and leadership and with

common understanding about potential benefits which can be derived from the FTA, I think these challenges can be overcome. We in East Asia must start with an East Asian FTA, but should not stop there. We must move aggressively towards forming a single market in East Asia and an East Asian community. By doing this, the Asian people will enjoy the prosperity, peace and progress.

Peter Drysdale: FTA's have so far been used on a bilateral basis and the question is whether on a bilateral basis they can deliver successfully on that interest. We then considered a broader strategy of regional trade arrangements, either based within East Asia or a broader Asia-Pacific framework, both of which are longer-term questions and interests on the agenda for regional integration.

Bhasu Bhanich Supapol: I would like to discuss financial integration for the region.

I think the framework for structural policy analysis and reform in economic development for the region can be summarized as follows. There appears to be at least two sides of the coin. The first is that structural reforms in the region can be the outcome of market forces, which we would call market-driven. On the other hand, there are reforms which are the results of deliberate policy design and implementation, which are named policy driven reforms. Second, structural reforms can take place either on a regional level or at the domestic level, in which case in this circle we would call it a behind-the-border structural reform as opposed to beyond-the-border structural reforms at the regional level. Lastly, there is the dichotomy between real sector integration and financial sector integration.

This leads us to the sequencing argument. Should the real sector integration precede the financial sector integration or vice versa? Regional trade integration before regional financial integration, or the other way around? There are two major and opposing lines of argument. The first line of argument contends that one needs a sufficiently high level of real sector integration to make entry into a monetary cooperation credible and sustainable. After deep real sector integration by liberalizing trade and factor movements, economic structures of countries will converge and at the very end, the entry into monetary cooperation culminating in the creation of a single currency would be achievable. The second and opposing line of argument contends that an early entry into monetary cooperation can be an impetus to further real sector integration. A common currency would force trading partners to share the adjustment costs of an aftershock. Monetary cooperation would be instrumental in performing real sector integration or prevent real sector integration from crumbling.

The debate can become very theoretical. However, this theoretical exercising so far has had little practical relevance for East Asia. Much of the effect of progress in regional integration has been market-driven and thus tends to take on a life of its own. Why doesn't public-sector policy designed to deliberately foster integration take us very far? Effective real economy integration in East Asia has been achieved mostly by market-driven, not so much policy driven trade arrangements.

Financial sector regional integration on the other hand needs to be policy driven and that policy needs to be regionally oriented as well as market infrastructure oriented. While behind-the-border reforms may be an effective way to regional integration especially for a real sector, beyond-the-border regional driven policy reforms are often inevitable, especially for the financial sector. The real sector is from an integration perspective not worrisome as intraregional trade has been moving forward relentlessly, partly thanks to the nature of the global value chain. Compared to financial integration, real sector integration does not seem to require as much a convergence among regional member countries in order for integration to take effect.

As Asia is maintaining competitive strength as a global production base, the consequent current-account surplus that has replaced the pre-crisis deficit can be expected to be sustained for many years to come. Although Asia currently has currency problems, the current-account was not the channel through which the 1997 Asian financial crisis erupted. The recession was rather a self-fulfilling capital account or balance of payments crisis as exemplified by sudden outflows of short-term portfolio capital.

It represents a combination of three failures attributable to policy maladies. The first element is sustaining a pegged exchange rate when is no longer suitable, the second, liberalizing the capital account when certain preconditions are not yet satisfied, and the third and most important element is lacking in financial regulation and risk management.

Even if Asia's downturn is best described as a capital account crisis, it also highlights institutional problems that fuel the crisis. One reason why financial markets in the open economies of ours have not developed in tandem with economic expansion is precisely institutional. With a weak financial system, lacking in market discipline and proper supervision, much of East Asia was ill-equipped to handle the large inflows. Unlike the capital account attributable as overnight, it takes years of learning by doing for prudential standards and enforcement tools to be rated. Restructuring, namely internal supervisory institutions and banking practices, should therefore be an ongoing, multiyear process, but continued, substantive processes of essential importance.

Peter Drysdale: We have heard about the importance of market-driven integration in the region and it follows from an emphasis that stresses the importance of pro-market policies, both in the real sector and in the financial sector, as the way forward in deepening and strengthening economic integration in the region.

Hadi Soesastro: What you have heard so far is that there is an idea of moving from bilateral and some regional FTAs to an East Asian or initially Asia-Pacific free trade area. That is one of the ideas we heard today. Another that we have heard is moving from the real sector integration into financial sector integration, eventually monetary integration.

I will complicate things further. I want to bring in a reality check to all the beautiful ideas that we have. Unfortunately, the region consists of very diverse members and countries and therefore one cannot be as logical as one wishes to be. One of the members of this enterprise either in East Asia or in Asia-Pacific is what is known as ASEAN, the 10 nations in Southeast Asia. For various reasons, maybe design, maybe default, maybe history, maybe geopolitics, they have been put in the driver's seat in all of these attempts to create regional structures and build regional communities in East Asia or the wider Asia-Pacific region. ASEAN has engaged itself in these various efforts. It began with an arrangement among countries in the region itself, which this year is going to be 40 years old. That gives ASEAN the legitimacy to be in the driver's seat.

ASEAN has a vision about community building in the region and has outlined a strategy known as the strategy of concentric circles of cooperation. You start with a smaller group and go larger and larger. When you begin with a smaller circle, you can strengthen yourself so that you can play a greater role and get a better share in the enterprise of community building. With that in mind, you can explain a lot about the behavior and policies on ASEAN in pursuing regional economic integration. ASEAN has moved ahead a few steps since 2003 when it agreed to form an ASEAN economic community, which in effect would transform a first-generation regional cooperation, the ASEAN free trade area, into the ASEAN economic community, which has a very comprehensive agenda. The objective of the ASEAN community is to create a single market and production base, to create a competitive economic region, to create a region of equitable economic growth and to create a region that is fully integrated into the global economy. That is the idea of an ASEAN economic community. Implicitly, it would require the ASEAN economies to undertake economic and structural reforms at home in order to be able to realize the ASEAN economic community. And structural reforms are not explicitly on the agenda of ASEAN today.

I would like to answer the question about what the optimal region for ASEAN would be. I think ASEAN has an open mind, but first of all it wants to strengthen ASEAN to this economic community and is now engaged in ASEAN + 3 with China, Japan, Korea and also + 6, bringing in India, Australia and New Zealand. They are at different stages. These are basically FTAs. First you have ASEAN + 3, which is to promote functional cooperation, including financial cooperation. Then there is the East Asian Summit or ASEAN + 6, which for some time to come will continue to be seen basically as a form for strategic issues in the region. Then you have APEC. Since 2003, APEC has put in its agenda a structural reform effort.

This provides an opening as to why this important issue of second-generation reforms can be attempted at the APEC level. We must have a clearer idea of what we are going to do where. We need a clear division of labor. But having said this, they will influence each other. You do not want to duplicate things too much in the region. Therefore, since Japan is going to host APEC in 2010, three years is not too long to begin to think about a very meaningful agenda for Japan to pursue structural reforms in the region. The difference between this approach and the approach you heard earlier from Dr. Lee is that Lee is trying to use the approach to economic reforms by imposing them from outside through a negotiated free trade agreement where I think the agenda in APEC is trying to develop a softer approach to economic reform on a regional basis.

Peter Drysdale: We have heard about the reality of diversity in the region, the different functions and platforms in the region and the APEC structure as a platform for structural reform. We have identified some ways to assist with structural reform and deepen integration in the region.

Gordon de Brouwer: Behind-the-border issues and structural reform refer generally to the whole system or reform of the whole system of regulation of firms and markets, competition and governance, both corporate-sector and public-sector governance. Over the past five years these issues have gained much interest. They are important to furthering cross-border business. They are also a source of productivity growth. And countries can increase the stability of their economies because they make their markets and their systems less vulnerable to shocks or crisis.

The question I would like to pose is that from these different perspectives, which forum is the most useful to address the behind-the-border structural reform issues. I would like to list my reasons why APEC may be the most useful forum for East Asia at this stage.

The first is that APEC is generally a market-oriented and principles-based forum for economic cooperation. This is very important because the whole mentality of APEC is to facilitate markets and facilitate business rather than

to intervene and direct. It is very much a mentality of facilitating markets and business in the Asia-Pacific.

The second is that APEC is not a negotiating forum. Its approach is generally to take voluntary and nonbinding approaches to agreement between economies in the Asia-Pacific. The behind-the-border issues are really domestic issues. When countries in the past have tried to negotiate these domestic issues as they did with the Singapore issues in the WTO, that process failed very quickly and miserably because they are not issues very easy to negotiate. We all know from our experience with our various FTAs that it is hard to make progress in negotiating procurement and competition issues in FTAs. These issues are behind-the-border, and they are inherently and intrinsically sensitive and internal issues.

APEC can help countries identify the key principles that underpin good markets, regulation, and governance. APEC is able to help developing countries prioritize them according to their own levels of needs. APEC can assist in building and strengthening domestic institutions and markets to enable these economies to function well. The nonbinding, voluntary nature of APEC is actually a real strength in addressing these types of very sensitive issues.

The third reason is that APEC has a mixture of experience on the behind-the-border issues and also has the ability to provide capacity building over the range of economies in Asia. This diversity is sometimes seen as a weakness but, in this context, the diversity of experience in APEC is actually a real strength. We have a range of both developed and developing economies with different insights into what works with markets, what sort of regulation is effective in markets, what works in practice. Also, having a range of developed economies in APEC means that there is a greater capacity to provide technical assistance. APEC also has a well-established tradition of bringing in experts. In this case, these are institutions like the World Bank and OECD—bringing these institutions that have the expertise, but doing it in a way that is relevant for APEC and Asian economies. We do not want to be in a position where the OECD tells Asia to do something, but we do want the insights of these institutions in a way that is relevant for Asian economies in the development.

Finally, I think APEC has an advantage because it has an established form and structure in place. Since 2003 and 2004 the focus in APEC has been on structural reform. That is Japan's initiative in 2004 put the implementation of structural reform on the agenda. It is an important agenda and is fixed within the APEC process. There is also the Economic Committee that has been revitalized and changed over the past few years under Dr. Lee's leadership to make it a policy forum rather than a research forum. One particular feature of

the Economic Committee is the actual membership of the committee. Usually, committees are focused on ministries: trade or finance, for example. However, there is no single common structural reform minister. The institution that is responsible for structural reform will differ from country to country. The Economic Committee is unique in that it brings together the institution of the government that are actually responsible for broader structural reform. I think there is already a mechanism in place, so it makes more sense to be efficient and use the process that is in there.

Peter Drysdale: We have heard about how regulatory and institutional systems have come to the forefront as impediments to effective operation of markets in the region. Addressing the problems is important to the regional economies as they seek more effective growth, productivity growth and economic integration. In line with this issue, diversity is a plus rather than a minus in terms of the variety of experience that is offered to regional economies confronting change and economic reform. The APEC structure is helpful in this respect because of its voluntary nature, which makes it easier and easier when policy change is a matter of national priority.

Masahiro Kuroda: There is a range of diversity, systems and economic development in the region. Economies must proceed on their own with structural reform. Economic integration in the region could be a good means of proceeding with structural reform, which I found to be an interesting point. I think you would like to include the regulation and micro institutional foundations. However, there are also macroeconomic options available to governments and can be exercised under the sovereign rights of each country. Are there any dichotomies or contradiction between microeconomic instruments and macroeconomic instruments?

Bhasu Bhanich Supapol: The microeconomic approach should not neglect the usefulness of market forces. That does not mean that the public sector no longer has a role. Through markets, the public sector can exert an influence on infrastructure and incentive building. In the financial stage, it is a fact that the credit market continues substantially to dominate the financial markets of the region and this is a characteristic that makes the region's financial sector vulnerable. There are regulatory and structural adjustment items to be covered both at the microstructure level and at the regional level. An example of behind-the-border microstructural reform in finance would be the creation of a level playing field through standardization of withholding taxes. That can be accomplished behind the border. Accounting and auditing conventions can be harmonized. For the capital market in particular, there is a clearing and settlement convention for which international best practices can be articulated. For regional enforcement, regional financial guarantees can be entered into,

and a regional credit ratings agency established through mutual recognition perhaps. A last example would be foreign-exchange regulations.

Kyung Tae Lee: Macroeconomic and microeconomic policy is just two sides of the same coin. Good economic policy requires sound macroeconomic policy and very flexible, market-oriented microeconomic policy. At the national level, it is self-evident that without microeconomic soundness, all the structural reforms of the micro level lose their effectiveness, and vice versa. At the regional level, as the East Asian and Asia-Pacific economies integrate by trading more, we need a well aligned foreign exchange rate among the major regional currencies. This is where we need macroeconomic coordination for foreign exchange rate stability together with structural reform to facilitate real sector integration.

Hadi Soesastro: This might be an indirect response to your question, but coming from Indonesia, I think given the history of its economic development and economic management, by now it is so well understood in the country how important maintaining macroeconomic stability is. And in fact the country has been able to do so in part because we know it is very important to have a good finance minister, in good governor of the central bank. So long as that is maintained, you can do it. On the microeconomic sign, it is a totally different story. Now it is almost chaotic in a country such as Indonesia because of political changes etc.

What we have learned is the following. In the previous year, President Suharto, following our decision to establish an ASEAN free trade area and agreeing on the Bogor goals, said, willing or not, like or not, we have to liberalize. He was a centralized government fan, but Indonesia wants access to the global economy and can only get it if we give access to our economy. In 1995 and 1996 we had unprecedented policy packages that gave a very clear schedule of tariff reductions for 10 years, not only for AFTA but also for most favored nations. The rationale of the government was, we're going to do this, but we'll give you time to adjust. That was possible. With the second-generation reforms, you can no longer do this. It is no longer that easy. You cannot just put together a policy package of tariff reductions. You need institutional changes, and all that. We will need a totally new approach both nationally and regionally. I think the experiment that is going on in APEC needs to be strengthened exactly because of that. National governments alone may not be able to resolve this very difficult problem and it needs to get support. Coming from Indonesia, I think we are very open to having support from other APEC members and I do not see this as something very intrusive. It could be, but depending on how you structure, it may not.

Gordon de Brouwer: I agree that the micro and macro are fundamentally complementary. A foundation of solid microeconomic policy will support

macroeconomic stability. In the regional context, the foundations for macro cooperation within Asia might be monetary policy or exchange rate determination. But even here, the micro foundations are very important. For example, domestic monetary policy is most effective when it can operate through a range of developed and domestically integrated financial markets, including bond and equity markets. If this is necessary for effective domestic monetary policy, then it is also necessary for effective coordination and cooperation in monetary and exchange rate policies. The microeconomic reform agenda is relevant. Access to a wide range of financial markets and instruments, well-defined property rights and legal systems, and effective insolvency regimes are all necessary for effective regional policy cooperation. Regional monetary cooperation cannot progress in any substantive way unless the deep and diverse financial markets are in place within Asia to support it.

Floor: When looking at micro and macro economic issues, I think that we need to remember the need for all citizens in a country to enjoy the improvements, for the gains to be distributed fairly and equitably. I would appreciate comments on how this can be accomplished

Kyung Tae Lee: Without undertaking domestic economic reforms, the potential benefit of economic integration will not be harvested. This is the emphasis for Korea when we pursue FTA with the US. We are now negotiating an FTA with the US. There are very strong critics against it. What we are trying to convey to the Korean people is that opening our market is only half of the story. The other half is to do what we should do domestically, and the combined effect will give us the real benefit of economic integration. As I understand your question on equitable income distribution, I have tried to answer how it can be equitably distributed among countries, but within countries is a very tricky question. The incumbent Korean government has been putting the highest priority of their social and economic agenda on improving income disparities. There are many different opinions on the solution. Some argue that we should create more jobs by fostering economic growth. Others argue that economic growth is not enough. We must strengthen the social welfare system and the social safety net.

Bhasu Bhanich Supapol: I believe some of the policy issues that I set out earlier could very well contribute to a more equitable distribution of income. To begin with, the East Asian region as a whole can be classified as net savers. The savings can be deployed across the region, but at the moment are invested in U.S. Treasury bills and government bonds, whereas there are a lot of investment opportunities in the region and to not have access to funding. Some of the measures proposed would help that. One is to redirect our attention to the capital market instead of the credit market by bypassing banking mediation. This will allow for smaller people to have access to money on the

market, people who cannot go to banks because they lack the proper collateral. Accounting and auditing conventions can adopt international best practices, which will allow small and medium-sized enterprises to have a better chance in the market. For small investors, harmonizing the trading platform (equity trading platform) across countries and allowing for class listings would open up opportunities. Mutual recognition across the region of credit ratings would allow small and medium-sized enterprises in the region to have a better chance of being recognized. None of these measures have direct and immediate impact, but they do contribute to the goal that you are seeking.

Peter Drysdale: In the earlier panel discussion this morning the focus was really on processes for supporting structural reform agendas within participating economies in the regional structure. A lot of the discussion in this session has been similarly focused. But in this morning's panel, the possibility was raised that there would be an interest for collective action on policy review and policy analysis. We will be looking for member economies within APEC or other structures to review policy reforms across the region. Given what you said about the interest in Indonesia, what do you think about the suggestion that there are opportunities for collective review policy performance and analysis?

Hadi Soesastro: The forum should be flexible enough in the sense that the needs of different economies at different times might be different. For instance, in the case of Indonesia today, we are struggling to improve a whole set of regulations affecting direct investment. There are some regulations that are problematic. How you can improve on this is a major question for us. Should we try to solve it on our own or can we bring it to a regional forum of sorts so that we can get additional input on improvements? My view is that maybe we should go further than this. If it is done in the APEC context, I believe the philosophy of APEC is to lend a helping hand and that is why it has been attractive for countries like Indonesia from the very beginning to join in. There is this promise that you might be given a helping hand in your efforts to improve things at home. The point still is that you have to do it at home. It is your task but you are given encouragement, support and assistance to improve on your capacity. I think some kind of delivery mechanism needs to be developed somehow. It should not be rigid. This requires more thought.

Gordon de Brouwer: If there is an appetite for countries to do some review process then we should welcome that. But there has to be a genuine appetite for review. I do not think it's possible to force countries to do a review process. What is important at this stage is to facilitate countries being able to share experience about what works and what does not and how countries prioritize and implement reform. It is also possible to do a lot of the substance of a

review without actually doing it in that form. You can get to the same sorts of findings and issues about markets and regulation and do it in a way that does make countries feel that they are 'on trial'. That probably fits in better with the APEC process. But I do agree that people should be open about this. It is really a matter of whether there is an appetite. It is useful for a broader social engagement on these issues, for people outside government forming views and providing their assessment of what is going on in a public way. This sort of information really does help inform a debate.

Peter Drysdale: We have been talking about how to carry out second-generation reforms in a regional context. We have learned from the panel that there is a central interest in a structural reform agenda, and in regional cooperation. A central question is which forum may usefully carry this agenda, and the suggestion is that APEC has the voluntary nature and structures to do this though they need to be strengthened. This effort is designed to support national reform agendas. There is still much to be done in development frameworks and strategies.

4. Closing

Masahiro Kuroda: We have enjoyed a very productive international forum. I find this exchange of views relevant and important. We must think about a framework under which our discussions will proceed. That is our task and mandate.