

ESRI International Forum
The Micro Foundations of East Asian Economic Integration
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Opening

Foundations for Success of East Asian and Pacific Integration

MC: [*speaks in Japanese*] Good morning, ladies and gentlemen. Thank you very much for waiting. First and foremost, thank you very much for joining us. We would like to welcome you to the international forum on “The Micro Foundations of East Asian Economic Integration” under the auspices of the Australian National University and ESRI or the Economic and Social Research Institute under the Cabinet Office. On behalf of the organizers I would like to invite from the Australian National University Prof. Peter Drysdale as well as Dr. Kuroda, the president of the Economic and Social Research Institute, for a few words, and then go on to Session 1. So we’d like to begin.

Masahiro Kuroda: [*speaks in Japanese*] Thank you very much, ladies and gentlemen. Allow me to introduce myself. My name is Kuroda. I am the president of the Economic and Social Research Institute of the Cabinet Office. First and foremost, thank you very much for attending this forum despite the early hour.

As was just introduced we have launched this project under the theme together with our colleagues at the Australian National University. It just so happens that yesterday at our research center or rather at our research institute we held a closed session and from the various countries we were able to invite authorities in this field. So today we are joined by these distinguished guests in this forum and we would like to talk about the role of Japan in the East Asian region going forward and also what possible collaboration Japan could achieve with these countries in order to vitalize trade and vitalize economy. What would be the methodologies involved. We addressed this very large or big topic. And today we wanted to have a forum whereby we could engage ourselves in open dialogue. So together with our colleagues at JCER we are able to host this open forum today. Although the time is limited, we do look forward to active exchange of views with all of you.

Now on behalf of the organizer, I would like to invite from the Australian National University, Prof. Drysdale, I would like to introduce Prof. Drysdale. If you would like to say a few words, please?

Peter Drysdale: Thanks very much, Dr. Kuroda. As Dr. Kuroda said, it's been a great pleasure to be working with ESRI and a range of research institutes throughout East Asia over the last year to look at the issues now confronting policy-makers in East Asia in their challenge in sustaining and promoting economic integration within the region on a stable and reliable basis.

Of course economic integration, the growth of trade and investment relations between our economies in the region, 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, investment and other business activities between the economies of the region successfully.

So in this work what we have been doing is looking at challenges for national policy-making and national policy-makers 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, and the way in which those national policies spill over into the interests of other economies in the region collectively, and promote a case for cooperation in policy-making. And we've looked of course at the way in which arrangements in the past within East Asia and across the Pacific, such as APEC, have promoted that process. We've looked at the way in which arrangements in more recent times, especially since the East Asian financial crisis, the ASEAN+3 process, and more recently the East Asia Summit process, are seeking to promote those interests. And our agenda is to try to define a way forward that promotes those interests that may be of use to policy-makers, especially in that dimension of their policy focused on regional cooperation.

There are particular interests in mind in that respect and we can keep those in the backs of our minds as we have panel discussions this morning. We have an East Asia Summit process and an ASEAN+3 process that's active. We have an APEC process that's active. The next APEC meeting is going to be held in September in Australia so there's a particular interest in looking at how the agenda for that meeting might be shaped consistently with our interests in deeper East Asian integration, and of course most importantly in this context Japan is to host an APEC summit here in Japan in 2010. So we're looking ahead at how the agenda will evolve in regional cooperation over the next several years. And it's on those topics that we'll focus today.

And I think the first conclusion that comes out of our work over the last nine months or a year, and this is the set of issues that will be taken up in the first panel, is that the region is moving from what might be called or has been

called by Hadi Soesastro, who is one of our panelists in the later session, a first generation of economic reforms upon which East Asian integration is being build, and those economic reforms can be characterized has having focused upon the barriers to developing relations among our economies at the border. The trade liberalization, the opening of trade, not the complete opening of trade, as you know we've still got a long way to go and there are agendas for freeing up trade in several dimensions that we'll discuss today, but there's been considerable success in the liberalization and opening of our economies in East Asia. They're in some sense a model for the first generation of economic reforms.

But now our economies are confronted by what might be thought of as a second generation of economic reforms and our panelists will talk about that in the first session, a set of reforms, a set of challenges that focus on issues behind the border, the regulatory institutions and other systems that inhibit the doing of business between our economies because of regulatory and institutional systems that are entrenched in national policy-making processes, so the second generation of reforms that promote regional economic integration will importantly devolve around dealing with those sorts of barriers to doing business more intensely among the East Asian and Pacific economies.

So with that introduction, I'm happy to pass over to Dr. Kuroda to chair the first panel.

Panel 1

Chair Kuroda: [*speaks in Japanese*] I would like to move into the very first panel discussion as was mentioned just now, what we have been analyzing and investigating in our research project. What are the necessary elements and as well the significance of the economic integration in East Asia and the Pacific?

Let me very briefly introduce the head panelists. Starting from the far distance, from ANU, Prof. Dee [*applause*]. And the second panelist is Dr. Yap from the Philippines Institute for Development Studies [*applause*], and the third panelist is Dr. Fan, assistant director from the Institute of World Economics and Politics of the Chinese Academy of Social Sciences [*applause*]. The last panelist I don't think I need to introduce to you, who is the private sector head member of the Council of Economic and Fiscal Policy and also a professor of ICU, Dr. Yashiro [*applause*].

I would like to ask each panelist, I have to apologize, the time is limited, but to speak for five to seven minutes each at the outset. Then may I call upon Prof. Dee?

Philippa Dee: Thank you, Dr. Kuroda. Thank you, ladies and gentlemen. The East Asian region has already achieved a remarkable degree of integration and I think it's fair to say that that has been mostly market-driven helped by the opening up of borders to allow the free flow of trade and investment. But as Prof. Drysdale said, we think it may be time to shift the focus to behind-the-border measures. And there are two reasons for that.

The first is that it's very important to ensure that we are safeguarding competition generally in our economies, not just protecting particular competitors. It's also very important to make sure that we have appropriate regulations in place in areas where productivity is very important but where the market alone may not produce the best outcomes. This is in areas such as infrastructure services, for example. But this 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. And 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 policy-making process, to try to find some of the principles of good domestic policy-making. And 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. So this involves taking into account costs and benefits not just in the particular part of the economy that's 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, taking into account the interests of governments as well as the private sector.

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

And the third principle is independent reviews of policy and policy options that embody the first two principle, 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 up better policy options as circumstances change.

You will hear from my colleagues shortly as they go through the process of deconstructing the policy-making processes in their own economies, and you will see how some of these principles have been manifest in their policy-making processes and you will hear their experience about what's worked and what hasn't and why.

As to the question of how regional cooperation can assist domestic governments, there are a number of possibilities that will be canvassed in the second panel. Some of these include things as simple of sharing experience about domestic policy-making processes. This is what we will begin this morning. There are other options that might involve particular countries, self-selecting for further assistance, not in a way that involves any compulsion but in a way where they volunteer themselves for further assistance, and that assistance may involve things such as helping them undertake policy reviews that can then feed into the domestic policy-making process without prejudging the outcome of that process. You will hear more about this in the second panel.

At this point I'd like to pass over to my colleagues who can take you through some of their recent experiences of domestic policy-making. Thank you.

Chair Kuroda: *[speaks in Japanese]* Thank you very much, Dr. Dee. Prof. Drysdale mentioned in the course of his summarization at the outset that the challenge for us today is as follows.

The challenge in the first generation was actually for our pursuit of economic integration. But now we're in the second stage. We have perhaps stepped up to the second step, or if you will the second stage or the second generation set of challenges, and they entail domestic competition policies as well as infrastructure for competition. How can these be developed in order to vitalize competition in the region?

At the same time, among the countries that take part in this economy, how can harmonization be achieved? These would be the next set of challenges which we must address.

Now the challenges for economic integration in the second generation, as was summarized by Dr. Dee, must follow several sets of principles, and based on these principles, the countries in this region must pursue collaboration. So we would like to further have discussion. So I would now like to invite Dr. Josef Yap who is the president of the Philippine Institute for Developmental Studies. Dr. Yap, please.

Josef Yap: Thank you, Dr. Kuroda. Ladies and gentlemen, good morning. It's always a pleasure to come to Japan. Japan is very close to my heart. I have a brother, a sister, a brother-in-law and a sister-in-law who all finished their degrees here in Japan.

I will not talk directly about the Philippines case. I will actually present a framework that this extension of what Prof. Dee earlier talked about. So my first slide shows the standard justifications for domestic regulation which are related to market failure. For economic regulation the justification is usually monopoly wherein the response is regulation of prices, regulation of profit and regulation of entry. And in the case of social regulation, you may have the situation of imperfect information and externalities so you have regulation that imposes pollution control or regulations that impose product standards.

However, these regulations can create distortions. You have domestic distortions that impose unnecessary costs and generate rents that lead to an unjust distribution of wealth. And then you have international distortions wherein there is discrimination against foreign products and foreign firms are not allowed entry, which generally leads to economic domestic inefficiency.

So the response to these distortions is regulatory reform, and the key elements are first competition policy, wherein you legislate competition policy. Earlier Prof. Dee mentioned some procedural requirements, one example of which is mandatory cost-benefit analysis, which can be considered as the second element of reform. The process has to satisfy certain criteria, like it should be economy-wide, transparent and there should be a regular policy review.

Now what I would like to talk about and emphasize is the third element of reform which is internationalization of the reform process. This actually forms the link between domestic regulatory reform on the one hand and regional global economic integration and cooperation on the other hand. And normally the internationalization of reform will involve type of agenda shown in the slide. This is an example. By the way the PowerPoint presentation is based on a short paper. I understand it was also translated. The agenda is usually summarized in promoting the law of one price. For example, you have

the issue of national treatment, harmonization of standards and then equal tax rates, and if you look at it from this perspective, it's usually how domestic regulation and regulatory reform will promote economic integration and economic cooperation.

However, internationalization also involves a feedback mechanism, how economic integration and cooperation can actually affect or accelerate the pace of domestic regulation and regulatory reform.

One argument is that internationalization provides additional leverage to policy-makers. When they try to institute reform they are able to cite as a reason their commitments to international fora or international treaties. Internationalization also provides broader attention and participation and it reduces the influence of narrow vested interests. Internationalization also exposes policy-makers to best practices, which allows them to formulate a blueprint that they can easily follow, a blueprint that they can show to the various stakeholders, domestic stakeholders, in order to convince them of the viability of the reform process. And then internationalization also entails mutuality in regulatory reform, meaning that both domestic participants and international participants are able to benefit from this regulatory reform. Of course internationalization enables policy-makers to lock in previous reforms that they have already instituted.

However, there are challenges and constraints to internationalization. One is the large disparity in economic development in the region. This prevents some countries from being able to take advantage of the opportunities provided by globalization and regional integration. In this context, some bilateral or even regional cooperation movements are very useful. For example, the Japan-Philippines Economic Partnership Agreement contains provisions for capability-building, for technology transfer, and for financial assistance. So it addresses this disparity in economic development.

There is also the problem of political and cultural diversity, which slows down or hampers the development of regional institutions that can promote closer economic cooperation and integration.

And then you also have the so-called nationalist argument wherein some sectors argue that sovereignty is threatened. And given this context, the issue is, what is the optimal regional grouping? Is it ASEAN+3? Is it APEC? What is the optimal regional grouping in order to address the large disparity in economic development, this political diversity and the so-called nationalist argument?

And I would just like to quote from the paper I circulated. So 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 thought of 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, the latter is largely voluntary so it's not very intrusive. But again, this limits the effectiveness of APEC because of non-binding commitments.

If the primary concern is narrowing the development gap, APEC has the advantage of having a wider spectrum of best practices to choose from. However, effective cooperation within APEC is also constrained by the number and geographical distance of the countries involved. A useful compromise may actually be ASEAN+6, which is ASEAN plus Japan, Korea, China and Australia, India and New Zealand. If mitigating political references in the region are very important, then ASEAN+3 actually lends itself to greater political and social cohesion. However, this discussion avoids providing prescriptions. So that ends my presentation. Thank you.
Arigatogozaimasu.

Chair Kuroda: [*speaks in Japanese*] Thank you very much, Dr. Yap. What was suggested by Prof. Dee, the second generation of economic reform, what should be the challenges, I believe Dr. Yap has made invaluable suggestions. As was said, in the first generation the competition policy would be important as domestic policy and how will be we able to bring about international harmonization which would be the key issue leading to the second generation of economic reform.

And in trying to forge forward such policies there could be several options. One thing is that amongst the countries with different economic development stages it would be difficult to try to harmonize the process. This would be one challenge. And secondly, the difference in the economic development stages, there are also diversities in political regimes as well as the economic and social regimes. So what are the constraints?

Depending on all these conditions, the options on the pathway toward integration may vary. That was suggested by Dr. Yap just now.

May I now turn to the third panelist, Dr. Fan from the Chinese Academy of Social Sciences. As we have seen in the discussion yesterday the dramatic growth of China is indeed worthy of our attention, and how should economic integration be proceeded for China with the other countries? Inclusive of the

comments made by the two previous speakers, may I ask Dr. Fan to enlighten us?

He Fan: Thank you, Dr. Kuroda. It's a great pleasure to be invited here. Today I will talk very briefly about the current economic situation of the Chinese economy and also I hope that China's case can help to explain Philippa's and Josef's argument that the 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 above 10 percent and the inflation is very low. And I'm quite confident that in the coming one or two years we can still maintain very high economic growth. But then it doesn't mean that we don't have problems. Actually we have a lot of serious problems, and a major challenge for macroeconomic policy is the internal and external imbalances.

By internal imbalance I mean we have an excessively high savings rate. The savings rate in China is now maybe one of the highest in the world. And why are households in China saving so much? And one reason is that we don't have a well-functioning social safety network. And so people in China have to save more for their retirement, for their unemployment, they are saving for health care, they are saving for education. This is called precautionary saving, and this excessively high precautionary saving has some very negative impact on the Chinese economy, because a very high savings rate means domestic consumption is not very strong, which means we have to rely on the foreign market for China's economic growth, and this is becoming more and more difficult in the future.

And by external imbalance I mean we have both, we have two surpluses. We have both a current account surplus and capital account surplus. And for the current account surplus it's easy to understand because we have a higher saving-debt investment, which means we have to export more to foreign countries. And this is a typical phenomenon for other countries, like other East Asian countries, Japan, they all have this experience. But then the puzzling phenomenon is why China also has the capital account surplus.

Chinese people are poor but we have no lack of money because we have a high savings rate. So why do we need so much FDI, so much capital inflow? And one reason is that we don't have a well-functioning domestic financial system. The domestic banking system, the domestic financial system doesn't play the role of transferring domestic savings to domestic investment, and this has created a very strange phenomenon we call round-tripping. So actually it's Chinese capital and then it flows out and then it comes back

disguising itself as foreign capital to take advantage of the preferential policy provided to FDIs and then to enjoy some other privileges like better protection of property rights and better treatment and better price for land, and a better price for workers and things like that. So this kind of round-tripping is also a waste of, it's a distortion of asset allocation.

So the policy implication is that in order to solve all these macro imbalances, we have to speed up the structural reform. And so we have to rebuild a nationwide social safety network and we have to speed up reform of the banking system and we have to invest more for human capital, to invest more for education, for public education and public health. So even though China's GDP growth rate is very high, but then the public investment on housing and education lag behind the growth rate of GDP. And this has a very dangerous implication for the future economic growth of China if we cannot solve these problems, and then we'll lose the momentum in the future for hyper-economic growth.

And in some sense China's experience may be unique, but then the Chinese story is not totally different from other countries in this region. And in this region we have many, many similar problems that we are facing. For example, I'm quite sympathetic to know that in Japan the productivity in the service sector is way below that of the manufacturing sector, because in China we have the same problem. And I'm trying very hard to understand the opening up of the financial system in Korea because we are also in the same progress. And I have kept a close eye on the turmoil in Thailand because a lot of Chinese scholars, they fear that maybe the next target will be China. We also have the same problem of a large amount of capital inflow and we are worried that maybe one day there will be a reversion of this movement and then we will have trouble.

So I think under this background we can better understand why the second generation reforms, the behind-the-border reforms in this region, are very important. We already have the FTA on the trade issues and we already have the Chiang Mai Initiative and Asian bond market for the monetary integration and APEC has laid an ideal platform for countries in this region to carry on this very important structural reform. Thank you.

Chair Kuroda: [*speaks in Japanese*] Thank you very much, Dr. Fan. You shared with us the current situation of the Chinese economy and you also pointed out some issues in the development going forward. Reform of the development policy in China would be required and I believe his point is common with the issues outlined by the two speakers in relation to the challenges of the second generation.

Also, in that context China has been able to learn from the lessons of the other countries in this region and is in a position to pursue further integration based on these lessons.

And last but not least, I would like to invite Dr. Yashiro and perhaps he will give his insight as to what Japan is doing in terms of development. What issues might be faced by Japan? Also various deregulation has been attempted that are market oriented. Perhaps he will be able to share with us his thoughts on the reform issue as well.

Naohiro Yashiro: [*speaks in Japanese*] Thank you very much. I've listened to the three distinguished speakers and they have been very eloquent and very straight-forward in terms of the need for structural reform. As Prof. Drysdale mentioned at the outset, the stages of epic integration began from the first generation, which was market oriented, and is now proceeding to the second generation whereby respective countries are now making efforts to develop infrastructure.

There are many reasons why this must be pursued. One such reason is the rapidly-progressing aging of our societies. Now the three top lines all show the situation in Japan. These indicate the trend of the population published every five years. You will find there is an accelerated aging going on in Japanese society. Now we only have a comparison in relation to China, but if you compare against the other East Asian countries, they are also experiencing a rapid aging process which is comparable to that in Japan.

Now the aging of society means that the practices and the rules which were instilled when the percentage of younger population was existent must be changed. However, unfortunately there is very strong resistance to changing the status quo.

Now this shows the economic growth, the real GDP growth for Japan. Up until the 1970s, where we had strong rapid economic growth, just like China today Japan was experiencing more than 10 percent economic growth per annum. However, it fell to 4 to 5 percent per annum later on, and since the 1990s, as you are aware, the economic growth rate rather has been hovering at about 1 or 2 percent. Some say that the boom today has exceeded the prior boom of Izanagi boom, however, it is simply the (lent) (CHECK) that we are talking about. We cannot say that the growth rate is strong enough.

Now under the new Abe government, in order to rapidly break out from the prolonged stagnation and in order to realize sustainable growth, a new growth strategy was formulated.

One point in this new growth strategy is the pursuit of IT. Up until now Japan was very strong in terms of creating IT technology per se, but in terms of the degree of the usage of IT, compared against other countries, Japan is lagging behind, so there is an imbalance as far as IT in Japan is concerned.

So especially in the service sector, how Japan can utilize information technology is going to be a crucial issue going forward. And tonight we are also going to be having a discussion at the Council on Economic and Fiscal Policy. And we will be focusing on structural reform in the academia with the perspective of IT.

And the second issue is openness. Of course APEC is one such pillar in Japan's efforts to further open up. However, not just through exports but also through imports it's necessary that Japan make attempts to vitalize its domestic industry.

The third issue would be deregulation. As was mentioned earlier, we need to shift away from the structure reform focused on economy to structural reform focused on society. In particular, when it comes to the health industry, this is going to be a growth industry as the society ages. So there is strong potential for this health industry going forward and the government needs to pursue deregulation so that this sector could be even more productive in the future.

Last but not least is the structural reform in the labor market. The Asian population means a decreasing population as well. And when we look at the next five years, the pace of decline in Japanese labor is going to be accelerating. In order to offset this we need further productivity growth.

As was mentioned earlier, in Japan we have a highly productive manufacturing sector, but a low productive service sector. So if you take a look at the aggregate you find that the level of productivity in Japan is low. But this also means that these represent a latent asset. In other words, if structural reform policies could concentrate on this low productivity sector, then there is still room and potential for further growth in productivity. So in order to do that, we must make IT investment even more effective.

And one such key would be FDI. Japan's FDI has been growing very rapidly. But on the other hand, investment from other countries into Japan, although it is increasing, the gap between outward FDI by Japanese and inward FDI have been quite large. So we need to have a market in Japan which would be attractive to foreign investors. To do that, various reform efforts must be made. The key I believe would be reform in the labor market.

And analogous to the big bang in the financial market in the past we would like to seek the so-called big bang in the labor market as well in the context of structural reform. So the very valuable human resources must be utilized in the most efficient manner to further improve productivity.

So for that, in the context of APEC, we need to pursue collaboration among the various countries and perhaps utilize a peer pressure of sort by saying that since other countries are doing so well or working so hard, Japan must be equal in terms of efforts being made. That's the message which we can make in this domestic market. So I think this would be a very critical key in terms of APEC cooperation. Thank you.

Chair Kuroda: Thank you very much, Dr. Yashiro. At the present moment the biggest problem faced by Japan is the aging of the society and the decline in our population. We are trying to bring about regulatory reform to try to improve on the productivity, and as one part of such process, economic integration would be an important means set for us.

Now we have just heard from four distinguished panelists on what is happening right now, and in the Asia-Pacific what would be the economic integration, the significance as well as the direction of integration? The so-called first generation of economic reform is now being completed. And how are we to bring about the second generation of economic reform within the economies on the border? How would we be able to have the good balance and relationship to be seen in the economic reforms happening in one economy and the economic integration process happening overall in the region?

If you have any questions, please. Now then Prof. Drysdale, can I hand it over to you?

Peter Drysdale: Thank you very much for those very interesting presentations. There were two questions that occurred to me as you set all the presentations side by side. When we are talking about the second generation reforms it's quite clear if you think and look at the country experience which He Fan described and the country focus which Prof. Yashiro talked about in Japan, there's going to be significant differences across countries in the priorities attaching to these reforms, a great deal of diversity in the interests in pursuing second generation reforms among countries in our region.

So 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 reforms may have been a simple matter of liberalizing trade at the border, reducing tariffs and commitment to that, among economies in the

region. But here we're faced with a whole range of interests and opportunities, and importantly a whole range of priorities in confronting the second generation reform issue.

And that relates to a second point. At the beginning of the panel, Dr. Dee identified three principles that were important perhaps in improving policy performance in respect of the delivery of second generation reforms. And that theme was carried through by Dr. Yap and in the discussion of He Fan and Prof. Yashiro. And as I recall, the three important principles she identified were having or developing an economy-wide focus in the process of policy development, so not looking at policy interventions from a one-off ad hoc viewpoint but assessing them within a framework of an economy-wide process of policy development.

The second principle was a principle of encouraging transparency in the policy-making process so before consideration of all the issues and effects of policies when they are developed.

And the third principle she identified was the principle of independent assessment of policy impact and policy performance.

So again, I wonder, these principles are found in principle, but when you apply them to these different circumstances in different economies, how would you make their application to improving the policy process, enhancing competitiveness, productivity and the strength of integration within the regional economies effective? Maybe it would be useful to have a response to those questions from all of the panelists if that's possible. But Dr. Dee might like to respond first.

Chair Kuroda: Prof. Dee, please?

Dee: Thank you, Peter. I think that's about 16 questions, not two. [*laughter*] Certainly there is diversity of policy priorities. My sense is that many countries are well aware of their own domestic policy problems. They have no difficulty identifying priorities. They may have difficulty pushing those priorities forward in the face of sometimes some quite strong resistance from particular segments of their domestic economy. And so I think we can comprehend diversity by letting each economy choose its own priority areas but perhaps giving assistance in the policy-making process. How the principles of an economy-wide view, transparency and independence apply in that instance is they apply to the policy process, not to the particular policy priority. And so it's a focus on process rather than a focus on particular areas of reform.

Chair Kuroda: [*speaks in Japanese*] Thank you very much. Then Dr. Yap, please?

Yap: Thank you. It's a very difficult question to answer. My answer would be non-economic. In the case of the Philippines, as I mentioned yesterday, we had a head-start in identifying appropriate policies to implement. What is making it difficult to implement the policies and these reforms, particularly regulatory reform, is the stranglehold of the elitist structure in our economy. I would say compared to other economies in Southeast Asia and even East Asia, our elitist structure is more defined, has a longer history and it has a stronger hold on the economy. And one example, I saw this study comparing bureaucracies across Southeast Asia. Whereas countries in East Asia apply meritocracy in running their bureaucracies, in the Philippines, patronage politics is very prevalent and this really affects the pace and effectiveness of reform. Thank you.

Chair Kuroda: Thank you very much. Dr. Fan, please.

Fan: It's true that each country has its priority of its domestic policy, but I think in an era of globalization it's not difficult to find issues in that countries in this region have some common interests. And one big issue is global imbalance because many countries in this region, they have similar challenges, the pressure for currency appreciation and the challenge on how to manage the accumulation of foreign exchange reserves. And this issue I think there should be more mutual understanding and more dialogue and maybe collective action in this region.

And second, I think in the financial system countries like Japan, Korea and China, and also quite a lot of Southeast Asian countries, they share the similarity that in their financial system, for example the banking system, take the lion's share and there is the underdevelopment of the bond market. So also this is a field that we need to further cooperate.

And there are some emerging issues like energy, because the whole region is now becoming a net importer of oil and other raw materials, and this has increased the vulnerability of the East Asian economy, and so in this issue I think there is also plenty of room for cooperation. And also environment because environmental issues are now crossing the boundary. It's becoming a global issue or an original issue. So the pollution in one country may spill over, the negative externality, and this is surely one area that countries in this region should work on.

Chair Kuroda: [*speaks in Japanese*] Thank you. Next, I would like to invite Dr. Yashiro.

Yashiro: Thank you, Prof. Drysdale. I think in addition to the APEC integration one of the key issues Japan is facing now is the Japan-Australian FTA negotiation which has just started. This is of very critical importance to Japan because Australia is a major agricultural-producing country while Japan's agriculture is quite weak. So if we open up the market right now I think the Australian agricultural companies will dominate in the domestic market. But I think it's a very good challenge for the Japanese policy-making.

Well, think back in the old days, we had the same experience because we set the target for liberalization of the automobile industry vis-à-vis quite strong United States car makers. And we set a target and we achieved it, we opened up the market. And Japan's automobile industries have not perished, I mean they are now overcoming the American industries right now. So the same thing may happen because why can't our agriculture so weak. Because we have plenty of land and we have a quite warm climate and we have abandoned water resources, and so it's entirely the failure of agricultural policy which has kept Japan's agriculture so weak in international competitiveness.

So if change the policy to a more appropriate way, then it's not impossible to improve the agricultural productivity and we can even export our agricultural products to Australians. So you see I think both the Japanese government and Japanese companies, it takes such a long time to decide something, but once we decide it's very quick to carry it out. So I hope that this agricultural liberalization vis-à-vis the Australian FTA is a very good challenge to try Japan's clear transparent policy-making as one of the structural reforms which now the government is targeting. So we will see in five years to come. Thank you.

Chair Kuroda: [*speaks in Japanese*] I'd like to thank the four speakers. We are under a time constraint and I wish that we could set aside more time to hear from our panelists. I think we have time to entertain maybe just one or two questions or comments from the floor. If there are any comments or questions to the presentations made so far, the microphone will be brought over to you, so please raise your hand if you wish to ask any questions or if you wish to make any comments from the floor. I know that the time was short. Perhaps you were not able to digest all the information, but any questions or comments from the floor. If there are any.

If not, then I think at the end we were able to talk about some of the issues involved in the realization of the second generation of integration. I'm sure that this could be reflected in our discussion in the second session as well. So perhaps I should hand over to the next session.

And in that context, how economic integration could be pursued so that it would be beneficial for the countries of this region. This would be one of the focuses of our discussion in Session 2, so I look forward to your continued participation. So we'd to close the first session at this juncture. We'd like to show our appreciation to our four panelists. Thank you. [*applause*]

Then may I ask the panelists to change cards, so to speak, so a few minutes of preparation.

Panel 2

Chair Drysdale: This panel focuses on the agenda for regional integration in East Asia and the Pacific and uses as a background the discussion we had in the first panel, but with the specific focus on what opportunities there may be to make progress through regional cooperation in second generation reform and enhancing the scope for regional integration.

And let me introduce our four panelists for this session. Our first panelist on the far left is Dr. Kyung-Tae Lee who is present from the Korean Institute for International Economic Policy in Seoul [*applause*]. The second panelist is Dr. Bhasu Bhanich Supapol who is from the Fiscal Policy Research Institute in Thailand [*applause*]. The third panelist is Dr. Hadi Soesastro who is executive director of the Center for Strategic and International Studies in Jakarta [*applause*]. The fourth panelist is Prof. Gordon de Brouwer who is from the Australian National University but also an officer of the Australian Treasury [*applause*].

So to set the scene in this panel, Dr. Lee.

Kyung-Tae Lee: Thank you. *Ohaiyogozaimasu*. I'd like to focus my brief presentation on free trade agreements in the Asia-Pacific region and/or East Asia region. And a free trade agreement has something to do or many things to do with structural reform which is the main theme of this conference, because the free trade agreement these days includes not only the manufacturing sector but also the service sector liberalization. And the service sector liberalization demands not only the elimination of the border barriers but to a greater extent it also calls for deregulation behind the border.

And another effect is that by having a free trade agreement, each sovereign state is under greater pressure for pursuing structural reform in their domestic economy to strengthen their economic competitiveness.

As we know, countries in the Asia-Pacific region have long supported a multilateral trading system, and because the progress in the ongoing Doha negotiation is very slow and also there are very rapid expansions of free trade agreements in other parts of the world. The bilateral free trade agreement between Asia-Pacific or East Asian countries reinforces the progress of trade liberalization and also it promotes the more domestic structural reforms in the countries of the region.

On the other hand, it seems that there are too many bilateral FTAs between Asia-Pacific countries, and this poses a risk of fragmenting the regional economy. So to avoid this risk of fragmenting the regional economy, we need the region-wide free trade agreement in the Asia Pacific or in East Asia. And the East Asia free trade agreement has long been studied and discussed, ever since the Asian financial crisis ten years ago.

There are many reasons for an East Asia FTA. The most fundamental cause for an East Asia FTA is to realize our long-term vision of building the East Asian community, the East Asian community in terms of a long-term perspective will be similar to the European Community.

But in parallel with the idea of an East Asia free trade agreement, more recently there is a new initiative to pursue a free trade agreement of the Asia-Pacific region. Last year, APEC leaders agreed to undertake further studies on regional economic integration in the Asia-Pacific region, including a free trade area of the Asia Pacific as a long-term perspective. Then the question is, between the East Asia FTA and Asia-Pacific FTA, which should come earlier? Then in my view we had better start with the East Asia FTA and then expand into a bigger integration, which is free trade area of the Asia Pacific, because as I have mentioned already, the East Asia FTA has been studied for almost one decade. On the other hand, the free trade agreement of the Asia-Pacific is relatively a new idea.

Then there are two key issues about the East Asia FTA. One is the membership issue; the other is the timing issue. The membership issue is, there are two competing ideas. One is that ASEAN+3 countries should be participating. The other idea is that ASEAN+6 countries should be participating. As was mentioned in the previous session, ASEAN+6 means ASEAN+3, plus Australia, New Zealand and India. In my view the answer depends on whether the participation of Australia, New Zealand and India make the real negotiation more difficult or not. If it is not, I think we can start from ASEAN+6 countries.

About the timing issue, when we had better start negotiations for an East Asia FTA. In my view the year 2010 seems to be very ideal. In that year Japan hosts the APEC Leaders Meeting and Japan might be able to exert the strong leadership to build consensus among member countries to launch negotiation of an East Asia FTA.

Of course there are many challenges for an East Asia FTA or free trade area of the Asia Pacific, but with strong political will and leadership and with common understanding about potential benefits which can be derived from the East Asia FTA, I think these challenges can be overcome.

So in conclusion, let me say that we East Asian people start with an East Asia FTA, then we do not stop there. We move progressively towards forming a single market in East Asia, and in the longer term we should envision to have an East Asian community. And along this line we Asian people can enjoy prosperity, peace and progress. *Domo arigatogozaimasu.*

Chair Drysdale: Dr. Lee in his presentation has focused on the broader issue of how FTAs have been pursued as an instrument for deepening the agenda for integration among partners in the region, so far on a bilateral basis, and the question of whether on a bilateral basis they can deliver successfully on that interest, which led him into a consideration of the 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.

So let me now turn to Dr. Bhasu for his contribution to the discussion.

Bhasu Bhanich Supapol: Thank you, Prof. Drysdale. Dr. Kuroda, distinguished participants, ladies and gentlemen, I thank you for this opportunity for me to speak at this public forum. Following Dr. Lee, who emphasized trade integration, I would like to turn to financial integration for the region. But first perhaps I could briefly summarize what I think is the framework for structural policy analysis and reform in economic development for the region.

There appears to be at least two sides of the coin. There appears to be a range of dual-dimension or dichotomies. The first one I'd like to point out in this framework is that policy reforms, structural reforms in the region, can be the outcome of market forces, which we would call these reforms market-driven. On the other hand, they are reforms which are the results of deliberate policy design and implementation. These would be named policy-driven reforms.

Secondly, 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 behind-the-border structural reforms as opposed to beyond-the-border structural reforms at the regional level.

And lastly, is the dichotomy between real sector integration and financial sector integration. This leads us to the sequencing argument whether real sector integration should precede financial sector integration or vice versa. Regional trade integration before regional financial integration, or the other way around?

The debate involves 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 in the manner that Dr. Lee just presented, the economic structures of countries would converge, and at the very end the entry into monetary cooperation up to the creation of a single currency would be achievable.

Meanwhile, the second and opposing line of argument contends that an early entry into monetary cooperation can even give an impetus to further real sector integration. A common currency would force trading partners to share the adjustment costs of an adverse shock. Monetary cooperation would thus be instrumental in promoting real sector integration or prevent real sector integration from crumbling.

The debate can become very theoretical, which we will leave out at the moment, however this theoretical exercise seems so far to have had little practical relevance for East Asia. I would like to argue that much of the effective progress in regional integration has been market-driven, and thus tends to take on a life of its own. Where it doesn't, public sector policy designed to deliberately influence regional integration often does not seem to take us very far either.

I hope to put across the idea that effective real sector integration in East Asia has been mostly 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. I would therefore argue that while behind-the-border reforms may be an effective way to regional integration, especially for the 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 intra-regional trade has been spurring relentlessly, partly thanks to the nature of the global value chain in cross-border production and trade within the region. Compared to financial integration, real sector integration does not seem to require as much convergence among regional member countries in order for integration to take effect.

As Asia is maintaining competitive strength as global production base, the consequent current account surplus that has replaced the pre-crisis deficit can be expected to be sustained in the many years to come.

Although Asia currently certainly had its currency problems, 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, exemplified by sudden outflows of short-term portfolio capital. The crisis represents a combination of three failures attributable to policy sub-optimality. The first element is sustaining a pegged exchange rate when it is no longer suitable. The second element is liberalizing capital account when certain preconditions are not yet satisfied. And the third element, and perhaps the most important, is lacking of financial regulation and risk management. Contagion, it can be argued, is fueled by crisis. The third element, institutional, that is, specifically, good governance or prudential norm. In short, even if Asia's downturn is best described as a capital account crisis, in some ways it also highlights institutional problems that fueled the crisis.

In closing I would say that one reason why financial markets in these 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 capital account, which can be liberalized overnight, it takes years of learning-by-doing for prudential standards and enforcement tools to be upgraded. Restructuring, namely, internal supervisory institutions and banking practices, therefore should be an ongoing, multi-year process but continued substantial progress is of essential importance.

And if time is remaining in another round I will take the opportunity to go more specifically into detail the strategy proposals at the micro level of how the financial sector integration should proceed. Thank you very much.

Chair Drysdale: Thank you very much, Dr. Bhasu. Dr. Bhasu has emphasized the importance of market-driven integration in the region, and it follows from that emphasis that he stressed the importance of essentially 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, and an implication also is that he is somewhat skeptical of the institutionalized attempts to promote regional integration. So there are some nice distinctions emerging in the positions that the panelists have taken.

Let's move on to Dr. Soesastro for a further contribution.

Hadi Soesastro: Thank you very much, Mr. Chairman, and ladies and gentlemen. What you have heard so far is that there is this idea of moving from bilateral and subregional FTAs into an East Asia or eventually Asia-Pacific free trade area. That's one.

Another one that you have heard just now is moving from the real sector integration into the financial sector, and eventually maybe also monetary integration for the region.

Now I'd like to complicate things further, but hope that you are not confused by it, by bringing in a reality check to all these beautiful ideas that we have, by saying that unfortunately the region consists of very diverse members and countries. And therefore, one cannot be as logical as one wishes to be. And so one of the members of this enterprise, either in East Asia or the Asia Pacific, is what is known as ASEAN, the Association of Southeast Asian Nations, the ten nations in Southeast Asia. Yet for various reasons, not by design, maybe by default, because of history, because of geopolitics, have been put in what is known as the driver's seat in all these attempts to create regional structures to build a regional community in East Asia or even in the wider Asia-Pacific region.

Well, ASEAN has engaged itself in these various efforts. It began with an arrangement amongst countries in the region itself, which this year is going to be 40 years old, ASEAN, and that in part gives ASEAN the legitimacy to be in the driver's seat, not the only but in part.

Well ASEAN has a vision about community-building in the region and ASEAN has sort of outlined a strategy, which is known as the Strategy of Concentric Circles of Cooperation. You know, start with the smaller one, move into the larger one and so on. And the idea there is that when you began with the smaller one you can strengthen yourself so that you can play a greater role, and in fact also get a better share in this whole enterprise of community-building. With that in mind, I think you can explain a lot of the behavior and policies of ASEAN in pursuing regional economic integration.

Well, ASEAN in fact has moved a few steps ahead now since 2003, when it agrees to form an ASEAN economic community, in fact transforming what can be called a first generation regional cooperation in Southeast Asia, namely, the ASEAN free trade area, into this ASEAN economic community which has a very comprehensive agenda. And the objective of the ASEAN economic community is fourfold: one is to create a single market and single production space; second is to create a competitive economic region; third is to create a region of equitable economic growth, and; fourth is to create a region that is fully integrated into the global economy. That's the idea of an ASEAN economic community.

Well, 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. But structural reforms are not explicitly in the agenda of ASEAN today. So I want to move now by taking up what Dr. Josef Yap initially asked, the big question of what is the optimal region then for ASEAN?

Well I think ASEAN has an open mind, but first of all it wants to strengthen ASEAN through this ASEAN economic community. It is now engaged in ASEAN+1 FTAs, with China, with Japan, Korea, India, Australia, New Zealand. And I think they are at different stages, but these are sort of basically FTAs. And then you have ASEAN+3, which is to promote functional cooperation including financial cooperation. And then you have the East Asia Summit, or ASEAN+6, which I think for some time to come will continue to be seen basically as a forum for dialogue on strategic issues in the region. And then you have APEC, and since 2003 APEC has in fact put in its agenda a structural reform effort for the region as a whole, and this I think provides an opening, at least to me, as to why this important issue of second generation reforms can be attempted at the APEC level. And I think not to confuse things we have to have a clear idea as to what we are going to do where. There should be this clear division of labor. But having said this, of course they all will have sort of influence on the other arrangements.

But you do not want to duplicate things too much in the region, and 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 these structural reforms in the region for APEC. And the difference between this approach and the approach that you heard earlier on from Dr. Lee, is that I would like to say, he was trying to use the heart approach towards economic reforms by imposing it from the outside through a negotiated free trade agreement. Whereas, I think the agenda that he is involved in in developing in the APEC Economic Committee is trying to develop a softer approach towards economic reform on a regional basis.

So I'll leave it at that. Thank you very much.

Chair Drysdale: Thank you very much, Hadi. Dr. Soesastro has taken as a starting point in his discussion the reality of diversity within the region that was talked about also in the first session: the ASEAN approach to developing cooperative arrangements around the reality of diversity in the region, identified the various platforms for regional cooperation as having different functionalities, focused on the APEC process as a platform for pursuing the structural reform effort, and identified some ways forward through what he calls a soft approach to self-imposing disciplines that will assist with structural reform and deeper integration in the region.

So that leads us to the final panelist in this session and that's Gordon de Brouwer. Over to you, Gordon.

Gordon de Brouwer: Thank you, Prof. Drysdale, and also Dr. Kuroda. My comments will really follow up I think from Dr. Hadi's comments. I think the behind-the-border issues or structure reform refers generally to the whole system of reform, of the whole system of regulation of firms and markets to competition frameworks and to governance, both corporate sector governance and also public sector governance.

Over the past five years or so the issues have become more and more important and there's a growing appetite to address them, and they seem to be very important because these sorts of reforms are very important for business. They seem to be in a sense the key impediment for firms doing cross-border business. These reforms are also a source of productivity growth. And they're also a way for countries to increase the stability in their economies because they make their markets, their systems, less vulnerable to shocks or crisis. So the scene is very important.

The question I'd like to pose, to follow-up Dr. Hadi's comments, is from East Asia's perspective, which forum for East Asia is actually the most useful to address these behind-the-border or structural reform issues.

And I'd like to go through very briefly four reasons why APEC actually may be the most useful forum for East Asia at this stage.

And the first of those is that APEC is generally a market-oriented and principles-based forum for economic cooperation. That's very important because the whole mentality of APEC is to facilitate markets, to facilitate business, rather than to intervene and direct or to take a dirigiste approach

to markets. So it's very much a mentality of facilitating markets and business in the Asia-Pacific.

The second reason is that APEC is not a negotiating forum. Its approach is generally to take voluntary and non-binding approaches to agreement between economies in the Asia-Pacific. And that's very important because these behind-the-border issues, these structural issues are really domestic issues. When countries in the past have tried to negotiate these domestic issues, as they did with the so-called Singapore issues in the WTO, the WTO, that process failed very fast and very miserably. They are not issues that are very easy to negotiate. And we all know from our experience with the various FTAs that some of the least progress is made in negotiating procurement, competition frameworks in FTAs. These issues are behind the border. They are inherently and intrinsically sensitive and internal issues. They are ones that are better addressed in a non-negotiating forum. And the sorts of things that are useful to address here are the key principles that underpin good markets, good regulation, good governance. How to prioritize for developing countries, according to their own level of experience? What's appropriate for their level of experience? And how to strengthen and build up domestic institutions and markets to enable these economies to function well. So that non-binding voluntary nature of APEC is actually its real strength in addressing these types of very sensitive issues.

The third reason is that APEC has a mix of experience on the behind-the-border issues, and it also has the ability to provide capacity-building to build up the range of economies in Asia.

Sometimes people talk about diversity as a weakness, but actually in this context the diversity of experience in APEC is actually a strength because it means that we have range of both developed and developing economies with different insights into what works with markets, what sort of regulation is effective in markets or what works in practice. Also, having a range of developed economies in APEC means that there's also a greater capacity there to provide technical assistance, and in fact we should be arguing, impressing more and more for this capacity-building within the APEC context.

APEC also has a well-established tradition of bringing in the experts, and in this case the experts are institutions like the World Bank, the OECD, but bringing these institutions in that have the expertise, but doing it in a way that's relevant for APEC economies, for Asian economies. So we don't want to be in a position where the OECD tells Asia to do this, but we want to be able to draw in the insights of these institutions in a way that's relevant for Asian economies in their development.

The fourth reason why I think APEC actually has an advantage for Asia here is that it has an established form and an established structure already in place. And the form is, as was mentioned before, is that history since 2003, 2004 of the focus on structural reform. That is Japan's initiative in 2004 on the Leaders Agenda to Implement Structural Reform, the LAISR. This is a really important agenda and it's embodied, it's fixed in within the APEC process.

But APEC also has this process to address that and that's called a thing called the Economic Committee. Now the Economic Committee has been renovated or revitalized or changed over the past few years under Dr. Lee's leadership to make it a policy forum rather than a research forum. And one particular feature of the Economic Committee that's very relevant here is the actual membership of that committee. Usually when you look at forums, they are very much a ministerial pillar. They are trade ministers' forums or finance ministry forums. When you think about structural reform, there is no single common type of structural reform minister. The person who's responsible for structural reform in countries differs substantially. In some cases, and in my country's case, it's the Treasurer, in Japan's case it's the Cabinet Office. In China's case it's the Minister for the National Development and Reform Commission. In Vietnam's case it the Minister for Planning and Investment. In Malaysia's case it's the prime minister and he does it through an Economic Planning Unit in the Prime Minister's Department.

The Economic Committee brings these different ministries to the table, based on functional responsibility. At the table, there is, for example, the coordinating ministry for the economy from Indonesia. It has the NDRC, the National Development and Reform Commission from China. It has the Cabinet Office from Japan. It has the Treasury from Australia. It has the Economic Planning Unit from the Prime Minister's Department from Malaysia. So it actually is unique in that it brings together the institutions within the government that are actually responsible for broader economic structural reform.

So I think there's already a mechanism in place, so it makes more sense to be efficient to use the process that's in place. So for those reasons I think that while there is a variety of forums in Asia, I'd like to endorse Dr. Hadi's comment that it is better to use a forum for the particular advantage it offers, and APEC in this context has, to my mind, a particular advantage in looking at and exploring further structural reform issues within Asia. Thank you.

Chair Drysdale: Thank you very much, Gordon. Gordon has emphasized the way in which regulatory and institutional systems have come to the forefront

as impediments to effective operation of markets in the region, and are seen to be such, and so addressing the problems there is important to the regional economies as they seek more effective growth, productivity growth and economic integration. In dealing with this issue, diversity is a plus rather than a minus in terms of the variety of experience that's offered to regional economies in confronting change and economic reform. And that the APEC structure is hopeful in this respect also because its voluntary character makes it easier in these areas where policy change is deeply a matter of national political interest and priority. It makes it easier for participants and members to sign on. And the APEC vehicle seems like, among the vehicles for economic cooperation, a good way of moving forward on this issue.

So we've had four very interesting, complementary presentations. I'm sure there might be some further discussions between the panelists, but remind the audience that the panelists are open to your questions as well, either as we proceed through the discussion among the panelists or we'll make a special space available at the end as well. But don't hesitate to raise questions for the panelists where you want to.

Dr. Kuroda was very kind to me in giving me an opportunity to ask the earlier panel a question before other people got a chance to ask them a question, and I've offered him a similar exchange so that mutual cooperation and reciprocity is working at the chairman's table here.

Kuroda: [*speaks in Japanese*] Thank you very much, Dr. Drysdale, for your kind suggestion. And I would like to thank all the four panelists for the very interesting and suggestive presentations. The four speakers have different perspectives, but if I may ask the question from a little bit different perspective.

Now for the second generation of economic integration to be realized, and we see diversity in the systems and the economic developments in the different countries, so the economies must on their own proceed with their structural reform, and the economic integration in the region could be one good means in proceeding with the structural reform, which was quite an interesting point raised.

But I'm sure you have in mind, including deregulation, the microscopic, the institutional foundations are being questioned here, and I do fully understand the points being made. But on the other hand, macroeconomic rather than microeconomic, the macroeconomic instruments are made available to the different governments and the macroeconomic instruments are to be exercised depending on the sovereign rights of each country. And in order to resolve the imbalance as we proceed with economic integration,

perhaps the macroeconomic instruments may be positive or sometimes detrimental. Or could there be any dichotomies or contradictions between the microeconomic instruments and the macroeconomic instruments or not? These are the points I would like to ask the panelists to please respond.

Chair Drysdale: The panel is open for response. Would anyone like to take the initiative in answering Dr. Kuroda's question? Dr. Bhasu?

Supapol: Thank you, Dr. Kuroda, Prof. Drysdale. I will answer by sticking to my original focus. The microeconomic approach, I think we should never neglect the usefulness of market forces, and by that it doesn't mean that the public sector no longer has a role because through markets the public sector can exert its influence through infrastructure and incentive-building. On the other hand, there is definitely room for policy at the macro level. There is room for both. I don't want to mislead into understanding that I'm putting more emphasis on one side than the other.

However, on 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 is a vulnerable one for the financial sector in the region.

As I promised earlier, at this opportunity, I think I did cover quite a bit of macro analysis at the earlier stage, so I'll turn to the more micro by saying that there are regulatory and structural adjustment items to be covered both at the micro structural level and at the regional level. I'll cite some quick examples.

For behind-the-border micro-structural reforms I would cite certain items such as level playing field creation through withholding tax standardization. That could be accomplished behind the border. There are accounting and auditing conventions that could be harmonized. For the capital market in particular, there is a clearing and settlement convention that could also be, of which international best practices can also be adopted. For regional enforcement, I would cite things as regional financial guarantee and a credit rating agency for the region, perhaps through mutual recognition. And as a last example, of course the foreign exchange regulations. Thank you.

Chair Drysdale: Thank you very much. Dr. Lee?

Lee: I think Dr. Kuroda is the best qualified to answer his own question. *[laughter]* But in my view, the macroeconomic policy and micro policy are just two sides of the same coin. Good economic policy requires both sound macroeconomic policy and very flexible market-oriented microeconomic policy. So at the national level it's very self-evident that without macroeconomic

soundness all the structural reforms at the micro level will mostly lose their effectiveness and vice versa. And that the regional level, as the East Asia or Asia-Pacific economies are integrated more by trading more, then we need a well-aligned foreign exchange rate among the major regional currencies, so this is where we need macroeconomic coordination for foreign exchange rate stability, together with structural reform to facilitate the real settlement integration. Thank you.

Chair Drysdale: Thank you. Hadi?

Soesastro: Well, it is maybe a very 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 they know it's very important to have a good finance minister, to have a good governor of the central bank, and so long as that is maintained you can do it.

Now on the microeconomic side, it's a totally different story. Now it is almost chaotic in a country such as Indonesia because of political changes and all that. And what we have learned in fact is the following. In the previous era of President Suharto, following our decision to establish an ASEAN free trade area and then agreeing on the proper course of APEC, he was the one that said, willing or not, like it or not, ready or not, we have to liberalize. And it was very well, it was sort of a centralized government then. But the message was rather clear saying that we want access to the global economy. We can only get it if we also give access to others into our economy. And this led to a policy package in May 1995, followed by another policy package in June 1996, which were unprecedented in Indonesia, namely, a very clear schedule of tariff reductions for ten years, not only for AFTA but also for MFN, going down. And the rationale of the government was we are going to do this but we give you time to adjust and very clear. So that was possible.

Now with the second generation reforms, you can no longer do this. It's no longer that easy, of simply have a policy package of tariff reductions. It's so much more complicated. You need institutional changes. You need regulatory changes and all that. And therefore, I think a totally new approach will need to be taken both nationally, as well as regionally. And I think the experiment that is going on in APEC needs to be strengthened exactly because of that, because national governments alone may not be able to resolve this very difficult problem and it needs to get support. And coming from Indonesia I think we're very open to having support from other APEC members. And I don't see this as something very intrusive. It could be. But depending on how you structure it, it may not. Thank you.

Chair Drysdale: Gordon?

Gordon de Brouwer: Thank you. I'd just like to first of all agree with Dr. Lee's comment that the micro and the macro are fundamentally complementary, that the right foundation of solid macro policy performance is on strong microeconomics.

But I'd like to make a comment that goes in the regional context about the foundations for macroeconomic policy cooperation within Asia. While some have aspirations for greater cooperation on exchange rates and monetary cooperation in Asia, solid micro foundations for that remain very important.

For example, market-based monetary policy relies on the setting of the overnight interest rate which affects, through expectations, a diverse range of financial prices, including of bonds, equities and the exchange rate. Unless those markets are developed and unless these markets are functioning well, the whole basis for the operation of monetary policy for monetary cooperation, is not there. It is not feasible to talk about monetary and exchange rate cooperation if the system of markets that underpin policymaking are not well-developed and effective.

And so this is where all of these things are related. For example, for financial markets what's really important, for example are well-defined property rights and well-defined insolvency regimes so that people know, when things go wrong, how those rights are apportioned. And that's exactly what the microeconomic reform agenda is about. So the micro foundations operate all the way through to the macro to my mind and they are fundamentally complementary. It is hard to see that regional monetary cooperation can progress in any substantive way unless the markets, broadly speaking, are in place within Asia to support that.

Chair Drysdale: Thank you, Gordon. We have plenty of questions to continue asking the panelists up here, but let me now invite the audience to put forward any questions or comments they may wish to the panelists. Yes.

Question (Takebe): [*speaks in Japanese*] Thank you very much. My name is Takebe. I am with IDE. I've been involved in a JICA project and I've been addressing the issue of integration in that capacity. So I would like to ask this question to you. It just so happens that the topic today, the topic of this forum, "The Micro Foundations of East Asian Economic Integration," this happens to be a very hot topic. The key words are regional integration, and also the issue is strategy.

When we talk about regional integration, last year I was involved in the study of the integration of the Latin American countries in the context of JICA. And at that time IDE was involved, we were talking about the ??? (CHECK), the shift from first generation to the second generation. But still this transition was not very smooth. At the background our problems are as follows.

While we can focus on the microeconomic development, we also have to focus on the micro foundations, such as income of the people and so forth. So it's not just a matter of macroeconomy. It's a matter of how can we develop a situation where the livelihood of all the citizens in the given country can be improved. Unless that focus is there then the regional integration may crumble. So as you are aware, while MERCOSUR is not working well and the Andes Agreement is also not functioning well in the Latin American countries.

So today we are talking about economic integration in East Asia, and I was very excited and I heard very exciting comments. But I would appreciate your comments on the importance of not just macroeconomic policies but the issue of equitable distribution of profit and wealth among the citizens. I think these questions will be very important. Maybe perhaps I am getting ahead of myself. Maybe there is a misconception. But are there any policy alternatives, policy options we can have that focus on the micro level issues in this region? Thank you.

Chair Drysdale: Let's just take a couple of comments from the panel on that. Dr. Lee, would you like to respond to the question?

Lee: I'm afraid I haven't caught your question exactly. First of all, we expect much economic gain from regional economic integration, but that gain is, to a large extent, potential. I mean, to realize the potential benefit, possibly it can be derived from regional economic integration. What we need is to do our homework quite well.

In other words, without undertaking the domestic economic reforms, then the potential benefit of economic integration will not be harvested in reality. So this is what the Korean people and Korean government have been emphasizing repeatedly when we pursue an FTA with the US. We are now negotiating with the US for an FTA and there are very strong critics against that. So what we are trying to convey to the Korean people is that to open 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 the economic integration.

And another question was I understand regarding the equitable income distribution of benefit, among countries or among people within countries? Which was your question? Both, I see. So equitable distribution of benefit among countries, I think that's what I tried to answer before.

And equitable distribution among people within countries, well, you know, this is a very tricky question. And the incumbent Korean government has been putting the highest priority of their economic and social agenda to improve this, the income disparity. But regarding the solution, how to solve this income inequality, there are many different opinions. Some people argue that to create more jobs by fostering economic growth is the best solution to improve income distribution. Other people argue that economic growth is not enough. We need to strengthen the social welfare system and the social safety net so there is still a very hot debate in Korea. Thank you very much.

Chair Drysdale: Dr. Bhasu, would you like to make a brief comment on that question?

Supapol: Yes. Measures to make the distribution of income more equitable is the question, and 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, and this tremendous savings could in one way or another be more equally distributed across the region, but instead the savings end up being invested in United States Treasury Bills and United States government bonds, whereas there are a lot of investing opportunities that await in the region but could not have access to this large sum of money. 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 the banking intermediation. This would allow for smaller people to have access to money in the market, people who cannot go to banks because they lack the proper collateral.

Accounting and auditing conventions, if they adopt international best practices, will allow small- and medium-sized enterprises to have a better chance in the market.

For small investors, harmonizing the trading platform, what I have in mind is an equity trading platform, across countries allowing for cross-listings, would open up opportunities for smaller investors who cannot do big lot trading. That would lead to more equitable opportunities. But of course there is fear when we talk about cross-listing that all the good stocks will move out

of a country and into a better trading market and the benefit will not be equally distributed. That's one fear.

Mutual recognition across the region in credit rating would allow small- and medium-sized enterprises in the region to have a better chance of being recognized and their stocks a better chance of making a better standing.

Withholding tax standards, of course if you can standardize the practice across the region, that would assist in making the distribution more equal. Of course all of these measures do not have a direct and immediate impact but they somehow go around and contribute to the same goals that you're looking for. Thank you.

Chair Drysdale: Thank you, Dr. Bhasu. We are unfortunately rapidly running out of time, we've perhaps run out of time, but I want to throw in one last question that may be of interest and importance out to the panel. Maybe I'll get Hadi and Gordon to comment on this.

In the earlier panel discussion this morning much of the focus was really on processes for supporting structural reform agendas within participating economies in the regional structure, and a lot of the discussion in this session has been similarly focused. But in this morning's panel, the earlier panel this morning, He Fan raised the possibility that there well might be an interest for collective action in respect of policy review and policy analysis, in other words, looking for member economies within APEC or whichever structure to review policy performance across the region.

I wonder what, given what you've said about the interests in Indonesia, Hadi, what you think about He Fan's suggestion, that there may also be opportunities for collective review of policy performance and analysis of policy performance.

Soesastro: Well, 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 the whole set of regulations affecting direct investment. And I think we are grappling with a few regulations. So how can you improve on it is of course a major question for us. Now, should we try to solve this on our own or can we bring it to a regional forum of sorts so that we can get a better, additional input to improving it, is that good enough?

Well, I have been of the view, maybe one should go a little further than this. Because it has to, if it's done in the APEC context, I believe the philosophy of APEC is to lend a helping hand and that's why it has been attractive for

countries like Indonesia from the very beginning to join APEC, is that there is the promise that you might be given a helping hand in your efforts to improve things at home. And the point still is that you have to do it at home. It's your task to do it, but you'll be given encouragement, you'll be given support, you'll be given assistance to improve on your capacity. And I thought some kind of a delivery mechanism needs to be developed somehow. But it should not be rigid. And we need to think a little bit more, of course, on this and maybe there are other ideas.

Chair Drysdale: Gordon?

Gordon de Brouwer: Just very briefly, if there's an appetite for countries to do some sort of review process, then we should welcome that, but there has to be the genuine appetite to do that. If they want to do it, then let them do it, but I don't think it's possible to force countries to do a review process.

The important step at this stage is to get a discussion to share of experience and insight about what works, what doesn't, how countries have prioritized reform and what they see as important. It is possible in fact to achieve much of the substance of a review without actually doing it as a formal review. Are there other means, are there other ways ahead that are going to be more useful to countries in Asia at this stage? Often you can get to the substance of the issues without doing it as a formal review, and that probably fits in better with the APEC process.

So I think people should be open about this and it's really just a matter of whether there's an appetite for review. That said, it still is useful for a broader social engagement on these issues, for people outside government, forming views and providing those views in a public way about their assessment of what's going on. That sort of information really does help inform a debate. Now that doesn't have to occur just within policy process but a broader social debate on these issues can be very useful and they can be important for building consensus around priorities and the importance of reform.

Chair Drysdale: Thanks very much, Gordon. What we've been talking about here is how to carry second generation reforms forward within the regional cooperative process. What we have learned I think clearly from the panel is that there's a central interest context in the structural reform agenda. It's become front and center of the interest in regional cooperation. A central question then is, which forum may usefully carry this agenda forward, and the suggestions that been that APEC is a useful form for carrying this forward because of its voluntary nature and its diverse structure. The observation has been made that nonetheless APEC structures need

strengthening further to do this effectively, and mention was made of the work already done in that respect in the Economic Committee and carrying that work forward.

And a particular emphasis through the discussion has been put on the ways in which this effort really is designed to support national reform agendas and the evolution of national reform agendas, and where appropriate, if the appetite is there for it, to look at these issues more broadly in a regional context from time to time as well. But there is a lot of work still to be done on that latter part of our conversation in terms of developing the right approaches, the right institutional framework and the right strategies.

So as I conclude this session and ask you to join with me in thanking the panelists, I'll just say that I look forward to working with our colleagues from around the region who have been party to this meeting this morning, and especially with Dr. Kuroda and his colleagues here at ESRI in continuing that work, especially as we proceed towards Japan's hosting of APEC in 2010. Thank you very much. [*applause*]

MC: [*speaks in Japanese*] I would like to thank Prof. Drysdale, Dr. Kuroda and all the panelists for the two panels. I would like to at the end ask Dr. Kuroda to say a few words.

Kuroda: [*speaks in Japanese*] For more than two hours, it was a very short period of time, but I believe we were able to have a very productive international forum. I would like to thank all of you for your kind participation.

In the East Asia and the Asia-Pacific, how we will be able to see more integration? This is indeed an urgent problem as we see the progress of globalization. What we have discussed in our two days' workshop, to share with you my own impressions, I thought that such a frank exchange of views was very important and very relevant. As we move forward to the second generation of economic integration, at what forum, in what framework should we proceed with our discussion is something we need think about. With transparency and in an independent manner we should proceed with our debate and discussion. And that is the task, the mandate, the mission given to us all, the researchers.

Now in holding this international symposium we were give the very kind support from influential research institutes and the eminent researchers, and I would like to thank all of you for your kind participation in submitting your papers, especially to Prof. Drysdale. For many, many years he has been the authority, the world authority if I may say so, and he has planned this

meeting and he has invited us to participate, and this has become indeed a huge asset, a huge hallmark for us, and I would like to thank Prof. Drysdale for kindly taking the initiative in this regard. I would like to also thank the Japan Center for Economic Research for your kind support.

Last but not least, I would like to thank the translation service, Simul International. Thank you very much for the good translation provided. I would like to thank them as well.

Thank you very much. It was a very short period of time but we were indeed very productive. Thank you. [*applause*]

MC: [*speaks in Japanese*] Thank you very much. We would like to conclude today's international forum at this juncture. You will find a question sheet in your reference material. May we ask you to kindly fill out the questionnaire sheet and hand them to our receptionist as you leave? Thank you very much.