

Regional Economic Integration and Inclusive Growth: Engaging Nations, Embracing People.

**A seminar marking the 10th Development Policy Research Month and the 35th Anniversary of the
Philippines Institute for Development Studies.
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In 2002, President Gloria Macapagal – Arroyo declared every September as Development Policy Research Month (DPRM). Since its proclamation, 10 DPRMs have covered a wide range of topics: responsive policymaking; affordable rice; services industries; local community; grassroots development; international migration; climate variability and change; poverty; education; and this year's Regional Economic Integration and Inclusive Growth: Engaging Nations, Embracing People. Regional economic integration grew from trade and the cooperative arrangements among firms it stimulated through cross-border investment and resultant technology transfers and knowledge spillovers. Higher economic growth and lower population growth reduced poverty but some areas have been left behind and the region experiences inequality and continued poverty. Globalized trade puts a premium on skilled workers and those without access to education are especially disadvantaged. Equity, and avoidance of opposition to continued regional economic integration both call for appropriate policy responses. The 2012 DPRM seminar therefore had a rich and significant agenda.

Asian Economic Integration Monitor, AEIM

1. The first session, *Asian Economic Integration Monitor – Regional Economic Integration: A balanced view*, was built on a presentation by James P. Villafuerte of the Office of Regional Economic Integration at the Asian Development Bank which drew on the latest *AEIM*. Its key messages are familiar: weak global growth will lead to rebalancing from external demand to domestic and regional; double-track growth will continue with Asia forging ahead through trade and finance, increased labour mobility and cross-border infrastructure, and increased cooperation; regional integration brings both benefits and costs so that further cooperation is needed to mitigate adverse impacts.
2. Trade integration reflects expanding regional production networks (as shown by the relative growth of trade in intermediate goods or parts and components); financial integration lags behind trade but is likely to increase and higher Japanese bank lending is already cushioning the impact of European bank deleveraging.
3. International migration is not well-documented; some is almost certainly disguised as tourism which, like remittances, suggests labour mobility has increased strongly.
4. Infrastructural connectivity, both hard (e.g. port capacity and roads) and soft (regulatory and institutional frameworks, systems and procedures) remains a high priority.
5. Mr. Villafuerte made the key points that Asian integration is market-driven, multispeed and multi-track. However, traditional ideas remain influential and the European example continues to dominate some thinking even after what is called the Global Financial Crisis but which is a North Atlantic crisis with international repercussions, regional in the same way as the Asian crisis of 1997. One participant even wanted to identify "integration" with Viner's sequencing of free trade area, customs union, monetary union and political union. That generalization of European developments predated the abandonment of fixed exchange rates and it is no longer sensible to partition trade and financial integration. (One merely has to think of the impact of exchange rate changes on investment flows as well as trade flows, and the consequent invalidation of traditional "elasticities" analyses of devaluation to recognise how much has changed since Viner wrote.) Rather than doubt whether Asia has yet progressed from "co-operation" to "integration", I would wonder if "integration" should be distinguished from "co-operation" and question the common claim that TPP is "leading edge" since it could not be sustained against the way Asian integration extends to transmigration, infrastructure, and development gaps.
6. Output correlations have risen in the 2008-9 financial crisis, and closer trade, investment and financial ties are likely to increase interdependence. Income dispersion has declined globally and within Asia although not in developing Asia other than China and India. It is odd, however, to assess the relationship between growth or integration and income dispersion by first excluding those areas where growth and integration is proceeding most quickly.

ASEAN Economic Community Mid-term Review

7. The President of PIDS, Josef Yap, introduced the second panel on the ASEAN Economic Community Mid-term Review with a wider reflection on Filipino participation in regional economic integration. The Philippines

shares the experience of a relative growth of intermediates or components in trade which is the effect of production networks but it lags in FDI and in manufacturing. Dr Yap developed a story: less educated, more poverty; manufacturing employs more less-educated workers than the services sector; and manufacturing is more productive and pays higher wages. So growth in the Philippines has been less inclusive. A more dynamic manufacturing sector or more education is the way forward. The notion of alternatives is attractive since it could point towards the importance of continued learning but I doubt whether we should put a great deal of weight on specific sectors. A.G.B. Fisher, who was one of the creators of the concept of sectors, was also a major opponent of the idea that New Zealand suffered from a “drift to the towns”; progress involves change in all sectors. It is also unwise to think of any sector is homogeneous; in the UK, around the time of World War I, the share of services in GDP and in employment was approximately constant, but this was because domestic service declined dramatically while professional services increased. The services sector was transformed. Even now, some services in the Philippines are relatively highly productive. International production networks are really well developed only in electronics, vehicles and garments industries. We can confidently expect them increasingly to spread to other industries, including food processing across the whole range from the farm gate to the most elaborately transformed products. (The initial observed effect is likely to be stimulation to Mekong Basin economies as production chains link South-east Asian agriculture to Chinese demand but both product range and geographic coverage will grow.) International production networks already depend on cross-border provision of services and again this can be expected to grow.

8. The session contained three good reports on PIDS work on AEC Scorecard. PIDS Fellow Erlinda M. Medalla dealt with trade liberalization and facilitation. ASEAN has rejuvenated the Philippines effort, and tariffs will be reduced as scheduled except for sugar and rice. Customs modernization, including a national (and eventually an ASEAN) single window is progressing. ASEAN is sometimes criticised for moving very slowly, concentrating on trade in goods and allowing exemptions too readily. The exclusion of sugar and rice certainly suggests caution, but it is not only in Aesop's *Fables* that the tortoise can eventually defeat the hare. Furthermore, trade in goods can be a framework for dealing with what is really important in the modern international economy, such as mutual agreement on technical standards.
9. PIDS Fellow Rafaelita M. Aldaba dealt with investment, linking it to the concept of a "single production base" which is a better approach than “single economic market” since it makes clear that the intent is to remove barriers to business rather than to harmonize all regulations as an end in itself. The Philippines is reasonably open to investment except for mass media (a relic of the constitution), land ownership and public utilities. (One might observe that the quality of Manila newspapers is not supportive of protection for domestic effort, they being one of the few capital medias which does not excel New Zealand's media in all major centres.) The Philippines is moving on reform within regulatory procedures and infrastructure.
10. PIDS Fellow Gilberto M. Llanto dealt with transport infrastructure where the issues are similar. Filipino transport companies are looking at logistics as an overall entity, in anticipation of the ASEAN Economic Community. Even air services, a notoriously difficult sector, is attracting attention to cabotage policy.
11. The three reports basically gave a positive picture of Filipino implementation of the ASEAN Economic Community, and PIDS has been a major contributor in working with ERIA to develop an economic assessment to go alongside the more administrative monitoring of the ASEAN Secretariat. None of the reports distinguished manufacturing from agriculture and services and the focus on responding to opportunities made available by integration is appropriate.

Small and Medium Enterprises in Globalized Economies: An Alternative Path to Inclusive Growth

12. Dionysius A. Narjoko from ERIA reported research on SMEs in ASEAN and China. Policy towards them is in the third pillar of the AEC - development gaps, the first being liberalization, the second being facilitation and the fourth being the location of ASEAN in the regional and global economy. SMEs (in electronics, vehicles and garments in ASEAN and China) join international production networks (IPNs) but at the fourth tier. They are flexible and low cost but also dispensable, and technological capability is a possible source of assurance. SMEs in IPNs mimic exporters - they are larger, younger, more likely to have some foreign ownership, and are innovative but process rather than product as they fit the standards of larger firms. Innovation, whether of product or process is a source of economic growth, and while adaptation to facilitation compliance with standards imposed by the production network as a whole is likely to only a modest gain in share of the overall value created, we should probably seek a direct assessment of the significance of specific innovations rather than use novel products as a proxy. Access to finance is an issue according to survey research, but I would be skeptical about reports of credit rationing rather than inability to meet conditions. Venture capitalists everywhere report many applications for funds to develop novel ideas which can be shown by a brief internet search to replicate innovations already made elsewhere. ERIA is developing a scorecard about whether policy discriminates against SMEs. There is also a lot of research on how clusters can be promoted and that extends to

FDI and Intellectual Property Regimes. There are also issues for SMEs to be addressed as FTAs are developed towards the Regional Comprehensive Economic Partnership, RCEP.

Corruption and the Local Business Environment: Insights from SMEs in 29 Philippine Cities

13. Ronald U. Mendoza presented a paper (with Joel E. Bancolita) from the Asian Institute of Management about corruption. Relevant research tends to fall into one of two categories: surveys of perceptions or reports of experience. Neither approach is conclusive on the competing theorized effects of corruption: "greasing the wheels" versus real productivity costs. Preliminary analysis by AIM of the correlates of corruption reported by SMEs suggests that the presence of a dynastic local executive is positively associated with corruption. One possible explanation is that a stable political dynasty entrenches a system that rationalizes rent-seeking, while political change could actually create uncertainty and generate corruption! Some results are reasonably clear: poor public goods provision seems to be strongly associated with corruption, and this opens the possibility that public goods are kept poorly provided in order to open opportunities for corruption and rent seeking. In my informal discussions, there was a lot of interest in the low incidence of corruption in New Zealand; this is a classic case of a good starting point contributing a lot to reaching a desired destination, but perhaps it is also important to avoid unnecessary regulatory requirements and to build in transparency.

Reflections

14. The seminar generated interesting material on the nature of regional economic integration. It reinforced the importance of contemplating development gaps, infrastructure and people movement alongside the elements of integration which get most attention in New Zealand – goods, services, intellectual property, etc. The treatment of SMEs within development gaps and international production networks is especially interesting.
15. We might also infer that Asian attention is being redirected from absolute poverty to relative poverty or inequality. This undoubtedly reflects the effect of economic growth, especially in developing Asia and within that, in China and India, in reducing the impact of absolute poverty.
16. On absolute poverty, relative poverty and inclusion, the most interesting recent discussion is Shaohua Chen and Martin Ravallion "More Relatively-Poor People in a Less Absolutely-Poor World" *World Bank Policy Research Working Paper* 6114 (July 2012). It notes that using the usual measure of poverty lines means that the "poverty" of people who have common standards of living depends on where they are living, but that looking only at absolute poverty – which has its own problems – ignores issues of social inclusion. The authors argue for "a weakly-relative measure as the upper-bound complement to the lower-bound provided by a standard absolute measure. New estimates of global poverty are presented, drawing on 850 household surveys spanning 125 countries over 1981-2008. The absolute line is \$1.25 a day at 2005 prices, while the relative line rises with the mean, at a gradient of 1:2 above \$1.25 a day. The authors show that these parameter choices are consistent with cross-country data on national poverty lines. The results indicate that the incidence of both absolute and weakly-relative poverty in the developing world has been falling since the 1990s, but more slowly for the relative measure. While the number of absolutely poor has fallen, the number of relatively poor has changed little since the 1990s, and is higher in 2008 than 1981." The connection between relative poverty and inequality is complex. The authors use a mean log deviation measure which is decomposable into within-country and between country inequality (as the Gini coefficient is not). They can then conclude:

We see that there has been a trend decrease in total inequality in the developing world, though with ups and downs, and an increase over 2005-08. However, that pattern has largely been due to inequality between countries. Over the period as a whole, we see that the between-country component has fallen while the within-country component has risen. The latter accounted for less than one third of inequality in the developing world as a whole in 1981, but almost half in 2008. This pattern has reversed since 2002, with inequality rising between countries but falling on average within. (pp. 19-20)

The overall conclusion of Chen and Ravallion is also complex: "The overall percentage of the population living below \$1.25 a day in 2008 was 22%, as compared to 52% in 1981" and absolute poverty has declined in all regions, especially in the 2000s. "The incidence of relative poverty has also fallen, from 63% in 1981 to 47% in 2008" but population growth means that unlike absolute poverty, total numbers of relatively poor have increased. So a substantial increase in the number of people who are relatively poor but no longer absolutely poor has come hand-in-hand with the developing world's success against absolute poverty. Economic growth has generally come with a lower absolute poverty rate but over time it has also meant that many developing countries have moved into the region in which relative considerations become more important. And the relative measures of poverty are naturally less responsive to economic growth—and more responsive to inequality. (p. 22)
17. Trends in inequality defy simple descriptions. It is tempting to rely on elementary equilibrium theory and expect capital to flow from where it is abundant to where it is scarce so that investment flows tend to equalize returns to labour and per capita incomes. That line of thinking has generated many thoughts about "capital flowing uphill"

as developing Asia has invested in developed countries. But we just as easily think about capital flowing not from rich to poor but from savers to locations where innovation is concentrated. Neither concentration of savers in Asia, or more than proportionate innovation occurring in the US is necessarily a permanent feature of the global economy, and nor has it occurred in isolation. Since the Asian Crisis of the late 1990s, it has been reinforced by policies in Asian economies to build up overseas reserves as an insurance policy against financial crises.

18. High savings rates will tend to increase income inequality; savings are not equally distributed and compound interest generates increasing inequality. But a tendency to greater inequality in cross-sectional distributions of income has been a common feature and not one limited to Asia. Wang Feng “The End of ‘Growth with Equity’? Economic Growth and Income Inequality in East Asia” *East-West Center Asia Pacific Issues* No 101 (July 2011) provides a sociological analysis of Asian experience. Using simple Gini coefficients, he argues that export-led industrialisation generated less inequality by (with the aid of education) giving young people incomes which they sent back to their rural families, and that this process was reversed because of “an unconstrained free-market ideology and the rise in power of multinational corporations challenging and undermining state and local authority” (p. 4) along with lack of redistribution schemes in the face of declining kin networks, and growth of services relative to manufacturing. There were undoubtedly some specific local influences in every region and economy but the “great compression” – or tendency towards less inequality in the middle of the twentieth century - was global, and extended to countries where rural-urban migration was not a major feature. The most likely general explanation is that technology and demand moved in directions which raised the relative incomes of young workers in a period of high population growth. (The most marked Asian distinctiveness was probably that social inequality was reflected not in conspicuous consumption but through control of company resources for private purposes although cultural pressures of collectivism may well have contributed more generally.) The recent trend towards inequality results from an increased value of skills related to learning and experience. The importance of this effect is suggested by the way that the limited evidence available suggests a general tendency for lifetime incomes to be distributed much less unequally than incomes measured cross-sectionally at a point of time. But much more is involved, including the diminished family size which enhances the significance of bequests and restricts social mobility.
19. A change of focus from absolute poverty to relative poverty, from poverty to inequality, requires reconsideration of the objectives of policy responses. Alleviation of poverty has an immediate basis in compassion when it relates to absolute poverty although even in those circumstances simplicity disappears when one considers the self-interest inherent in ensuring that society can utilize all available human resources. The policy objectives of diminishing inequality are even less obvious. Probably the strongest is what has recently been expressed by Stiglitz as:
“When one interest group holds too much power, it succeeds in getting policies that benefit itself, rather than policies that would benefit society as a whole.”
(quoted by Dante Chinni “‘The Price of Inequality’ and ‘The Betrayal of the American Dream’” *Washington Post* [25 August 2012].) The argument is that inequality undermines confidence in government and belief in the rule of law. A narrower economic argument is that it undermines worker efficiency.
20. A second policy objective related to inequality is promotion of social mobility, again driven eventually by a sense of fairness or desire to ensure opportunities for all skills and aptitudes to contribute to society. It is a significant element in US politics. Michael Gerson “Romney can gain upper hand on economic policy by focusing on class” *Washington Post* (13 July 2012) uses a recent report on an Economic Mobility Project of the Pew Charitable Trusts to set the issues of class and distribution in a dynamic setting emphasizing how American mobility has fallen below some European countries whereas “The American ideal requires a realistic prospect of turning ability into achievement.” In a related manner, we might see the Asian emphasis on inclusiveness as having a substantial element of concern to maintain social mobility.
21. However unlike the objective of poverty alleviation, where the concept of an optimal level of poverty is hardly coherent, it is sensible to ask what level of inequality we want. There is a need for balance between prosperity and security, between incentives and social cohesion (not unlike the balance between encouragement of invention and gains from dissemination of knowledge which should be the basis for determining Intellectual Property issues). It is unusual for the question to be posed so directly but all developed countries are grappling with it in the form of managing their welfare systems. Public transfers that moved beyond alleviation of absolute poverty made beneficiaries into influential political interests with a strong sense of entitlement. Defence of “rights” can undermine confidence in government, the rule of law, and worker efficiency just as readily as the greed of the rich. The leader, “Asia’s next revolution”, *Economist* 404 (8801) (8 September 2012) pp. 11-12, suggests that Asia faces specific problems – the growth of ageing populations, and sheer size and the informal nature of many economic and social relationships which makes it difficult to reach target groups. Its suggestions

that Asia should pay particular attention to affordability over time, careful targeting (and avoiding things like regressive university education support), and ensuring flexibility and innovation, and are all sensible.

22. Reflections like these on appropriate policy responses to inequality tend to assume national policies. There are obvious links to regional integration, especially when that includes a significant degree of labour mobility. Migrants' entitlements to welfare benefits quickly become contentious, while migration flows can be motivated by differences in national welfare systems rather than economic opportunities. Furthermore, simply because rising inequality and economic integration occur together, there are many suggestions that one causes the other.
23. It is notable that the *Asian Economic Integration Monitor* (ADB July 2012), p. 55 concludes that the European experience of regional integration is that it promotes equality – political or institutional forces outweigh economic ones. The important mechanism may be that economic actors follow similar rules and processes and markets increase in size. There is nothing in the identified mechanisms that suggest that the impact of politically-driven, institutionalised integration in Europe is different in this respect from the market-driven integration of Asia. But the suggested mechanisms do suggest that the equalizing impact will depend even more on financial integration than on trade integration – especially through the effect of financial integration in facilitating risk-sharing across national boundaries - and financial integration had lagged behind trade integration everywhere, but especially in Asia.
24. The importance of economic processes and market size along with rules reminds us that more is involved than government transfer schemes. The role of education in facilitating employment is well accepted as in para 7 and in the formulation of the issues for the seminar as stated above. There is room for more acceptance of the conclusion now common in education discussions about the importance of moving beyond the notion of education as a distinct stage of life before entry into the world of employment to recognition of “lifetime learning” and the conclusion that the most important skill is ability to go on learning – adaptability to new knowledge is central to both individual mobility and aggregate economic growth. “Inclusive” growth is both an economic and a social objective.
25. The APEC growth agenda promoted by the Japanese government in 2010 emphasized both inclusive and innovative growth, and as was implicit throughout the PIDS seminar, both goals remain basic to regional discussion of economic integration. There is a lot of debate in North Atlantic countries and elsewhere about the effect of fiscal stimulus, e.g. Lawrence Summers “Learning from Britain’s fiscal model” *Washington Post* (18 September, 2012). The framework of “growth versus austerity” is especially sterile as the important issue is what action is most likely to facilitate economic growth. Facilitating the participation of SMEs in international production networks, including their participation in innovation and increasing their share of the eventual value created by consumer demand, is a much more fruitful framework. It deals simultaneously with promoting both economic growth and social inclusion. Regional integration, pursued in the Asian manner, is clearly likely to promote both.

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