ASIAN ECONOMIC INTEGRATION REPORT 2015

HOW CAN SPECIAL ECONOMIC ZONES CATALYZE ECONOMIC DEVELOPMENT?

ADB

ASIAN DEVELOPMENT BANK

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Note: In this publication, "$" refers to US dollars.
ADB recognizes "China" by the name "People's Republic of China."

Contents

Abbreviations

ADB	Asian Development Bank
ADO	Asian Development Outlook
AFC	Asian financial crisis
APEC	Asia-Pacific Economic Cooperation
ARIC	Asia Regional Integration Center
ASEAN	Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam)
ASEAN+3	ASEAN plus the People's Republic of China, Japan, and the Republic of Korea
ASEAN-4	Indonesia, Malaysia, the Philippines, and Thailand
ASEAN-5	Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam
ASEAN+6	ASEAN+3 plus Australia, India, and New Zealand
BEC	Broad Economic Categories
BEPZA	Bangladesh Export Processing Zone Authority
CAREC	Central Asia Regional Economic Cooperation
CLMV	Cambodia, Lao People's Democratic Republic, Myanmar, and Viet Nam
CPIS	Coordinated Portfolio Investment Survey
DMC	developing member country
DVA	domestic value-added absorbed abroad
EFTA	European Free Trade Association
EOE	electrical and optical equipment
EPZ	export processing zone
EPZA	Export Processing Zone Authority
ETDZ	Economic and Technological Development Zone
EU	European Union
euro area	Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain
FDI	foreign direct investment
FTAAP	Free Trade Area of Asia-Pacific
FTA	free trade agreement
FTZ	free trade zone
FVA	foreign-value added
FY	fiscal year
G20	Group of Twenty (Argentina, Australia, Brazil, Canada, the People's Republic of China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russian Federation, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and European Union)
G3	Group of Three (euro area, Japan, and the United States)
GDP	gross domestic product
GFC	global financial crisis
GME	growth miracle economies (the People's Republic of China; Hong Kong, China; the Republic of Korea; and Singapore)
GMM	generalized method of moments
GMS	Greater Mekong Subregion
GVC	global value chain
HTDZ	High-Tech Development Zone
IMF	International Monetary Fund
ICT	information and communication technology
IP	intellectual property
ISDS	investor-state dispute settlement
LHS	left-hand scale
M&A	mergers and acquisitions
MNC	multinational corporations
MTR	multilateral trade resistance
NIES	newly industrialized economies
OECD	Organisation for Economic Co-operation and Development
OLS	ordinary least squares
PDC	purely double-counted terms
PPP	public-private partnership
PRC	People's Republic of China
RCEP	Regional Comprehensive Economic Partnership
RCI	regional cooperation and integration
REC	regional economic corridor
RHS	right-hand scale
RKC	Revised Kyoto Convention
ROW	rest of the world
SASEC	South Asia Subregional Economic Cooperation
SEZ	special economic zone
SGZ	special governance zone
SME	small and medium enterprise
SOE	state-owned enterprise
SVAR	structural vector autoregression
TFA	Trade Facilitation Agreement
TFP	Trade Finance Program
TTIP	Transatlantic Trade and Investment Partnership
TPA	trade promotion authority
TPM	technological protection measure
TPP	Trans-Pacific Partnership
UNCTAD	United Nations Conference on Trade and Development
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
US	United States
VSI	vertically specialized industrialization
WB	World Bank
WBES	World Bank Enterprise Survey
WCO	World Customs Organization
WEO	World Economic Outlook
WIOD	World Input-Output Database
WTO	World Trade Organization
y-o-y	year-on-year

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AEIR 2015—Highlights

Asia's trade has slowed faster than world trade; trade growth has been below economic growth since 2012. Structural factors such as slower expansion of global value chains and growth moderation in the People's Republic of China may be at play, but the region must embrace further efforts to make trade and investment regimes more open. Regional trade blocs such as the Trans-Pacific Partnership and the proposed Regional Comprehensive Economic Partnership could facilitate freer trade if supported through open, flexible accession.

Asia has emerged as an important source of outward foreign direct investment (FDI). Asia's outward FDI increased faster than inward FDI—growing 45.3% in 2014 compared with 2010, led by both the region's high income and emerging market economies. FDI is the most stable source of capital for the region compared with more volatile equity, debt, and bank-related flows.

Special economic zones (SEZs) can play a catalytic role in economic development, provided the right business environment and policies are put in place. In Asia, SEZs can facilitate trade, investment, and policy reform at a time the region is experiencing a slowdown in trade and economic growth. For SEZs to be successful, they must establish strong backward and forward linkages with the overall economy. Effective SEZs must be an integral part of dynamic national development strategies and evolve as economies develop by transforming from manufacturing bases to technological platforms for innovation and modern services.

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Trade Integration

- **Asia's trade growth has slowed due to slower global value chain (GVC) expansion and growth moderation in the People's Republic of China (PRC).** By volume, Asia's trade growth has fallen faster than world trade and has been below gross domestic product (GDP) growth since 2012. Asia's income elasticity of trade declined from 2.69 before the global financial crisis (GFC) to 1.30 afterwards—meaning trade is growing less for the same one-percentage increase in GDP than before. There are several interrelated structural reasons: (i) in general, Asia's economies are rebalancing away from exports and investment toward consumption and services; (ii) global and regional value chains appear to be maturing after decades of rapid expansion; in Asia, intermediate goods trade—almost 60% of the region's total—declined 2.6% in 2014 in value; and (iii) given the PRC's high weight in intraregional trade, its growth moderation reduces export growth across the region.

- **The Trans-Pacific Partnership (TPP) could be a stepping stone toward further global trade liberalization.** Intraregional trade has hovered at 55% of total Asian trade since 2011—below the European Union's (EU) 65%, yet above North America's 42%. When in force, the 12-member TPP (Australia, Brunei Darussalam, Chile, Canada, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States [US], and Viet Nam) will likely affect Asia's production networks and trade links significantly. The TPP could also stimulate structural reforms beyond trade liberalization. Regional trade blocs such as the TPP—and the proposed Regional Comprehensive Economic Partnership (RCEP), which includes the 10 ASEAN members plus Australia, the PRC, India, Japan, the Republic of Korea, and New Zealand—could facilitate freer global trade, particularly with open accession.

- **The PRC's transformation toward more consumption- and services-led growth presents both challenges and opportunities for other economies.** With PRC growth moderating and its moving from an investment and export driven growth strategy to one led more by consumption and services, many economies in East Asia, Southeast Asia, and Oceania that supply raw materials or export parts and components to the PRC could face growing challenges in adjusting to these. However, expanding consumption in the PRC could expand market opportunities for consumption goods exports and investments in the related industries from the region.

Financial integration

- **The composition of capital flows matters for financial stability.** Inward foreign direct investment (FDI)—from outside and within the region—grew 26.3% (to $495 billion) from 2010 to 2014. Equity and debt inflows, however, decreased 20.1% and 59.4%, respectively, while bank credit has fluctuated across years. FDI is the most stable source of capital compared with more volatile equity, debt, and bank-related flows. Using the standard deviation of inflows into Asia as a percentage of GDP, inflow volatility was 0.6 for FDI during 2005Q1–2014Q1, 1.4 for equity and 1.5 for debt. Uncertainty over US interest rate policy contributed to capital flow volatility.

- **Asia has become an important source of outward FDI.** External and intraregional Asian FDI outflows increased faster than FDI inflows—growing 45.3% in 2014 compared with 2010, led by investments from traditional investors—including Japan; Hong Kong, China; and Singapore. While outward equity investment increased 91.6%, outward debt investment fell 178%. In 2014, outward equity investment mostly went to the euro area and other advanced economies, while outward debt investment to the US rose.

- **Investments from emerging Asian investors are also rising, particularly in developed economies.** Emerging Asian investors—such as the PRC, India, Malaysia, and Thailand—are increasing investments into Europe, the US, and Latin America. India has become the third largest source of inward FDI for the United Kingdom (UK) after the US and France in number of projects, while Thailand has increased investment in Italy and other European countries. The PRC increased its investments in utilities and logistics in particular in countries like Italy, Portugal, and Spain.

People Movement

- **Asia is the world's largest source of international migrants.** In 2013, 79.5 million people from Asia migrated to other countries—accounting for 34% of the global total (231.5 million). South Asia was the largest source, contributing 44% of the Asian total. Second was Southeast Asia, as ASEAN integration boosted both migration and tourism. Income disparities and demographics drive Asian migration. In general, economies with low income and large numbers of young (20-34), working age populations (Afghanistan, Bangladesh, and India, for example) are net sources of migrants. Those with high income and ageing populations (Australia, Japan, and New Zealand, for example) are net recipients.

- **Remittances and tourism remain important sources of income for many Asian economies.** Asia accounted for nearly 50% of global remittances ($583.4 billion) in 2014. India, the PRC, and the Philippines received the most—$163 billion, or 61% of the Asian total. As % of GDP, however, Tajikistan, Nepal, and the Kyrgyz Republic were largest with 41.9%, 29.9%, and 29.4% of GDP, respectively. Economies that rely heavily on remittances for income also tend to experience high volatility in remittance inflows. These economies should continue to pursue industrialization and economic diversification to make their economies more resilient and provide more domestic job opportunities.

Special Chapter: How Can Special Economic Zones Catalyze Economic Development?

Evolution of Special Economic Zones (SEZs)

- **Economic zones are proliferating, yet performance is mixed.** From an estimated 500 SEZs in 1995, there are now some 4,300 in over 130 countries (by the most recent count), employing more than 68 million workers. While many are successful, others are poorly run or never take off. Nonetheless, they are attracting renewed attention with more developing Asian economies using SEZs as a policy tool to promote industrialization and economic growth.

- **Economic zones have played a key role in economic development in many Asian economies.** The earliest SEZs in Asia grew within a context of relatively closed economies. They were designed to circumvent trade restrictions and earn foreign exchange revenues. The rationale was that large, nationwide economic benefits from these experiments far outweighed fiscal and other economic costs incurred by the temporary price and incentive distortions within SEZ enclaves. They also aimed to widen the manufacturing base and begin establishing a foothold in the global marketplace. Over time, in many countries, SEZs have paid high dividends in job creation, increased exports, and larger FDI—even if over-ambition or lack of strategic focus at times led to failure. SEZs were also used as testing grounds for incentives and structural reforms that could later spread across the economy to overcome development constraints.

- **Different SEZ stages coexist in developing Asia.** First stage enclave-type SEZs help generate employment and foreign exchange revenues. For example, SEZs in Cambodia remain relatively small and new, employing low-skilled workers in industries such as garments, electronics, and household furnishings. Second stage zones help diversify an economy's production base by strengthening linkages with the domestic economy—for example, Malaysia and Thailand moved from assembling imported inputs to increasing sales of their own branded merchandise in domestic and global markets. Third stage zones can bring nationwide developmental impact facilitated through certain reforms in areas such as the labor market and service sector. This improves productivity, promotes innovation, and strengthens skill development—as seen in the PRC; the Republic of Korea; and Taipei,China.

Economic impact of SEZs

- **Successful SEZs help expand exports and investments.** According to estimations conducted on Asian economies, the number and presence of SEZs in an economy are positively related to overall export performance and volume of inward FDI. On average, a 10% increase in the number of SEZs increases manufacturing exports by 1.1%—based on estimations for the region's economies with available data. This suggests SEZs do more than just reallocate exports and inward FDI into SEZs.

- **Still, SEZ performance varies widely across economies.** Measured by firm-level output (proxied by sales), exports, and productivity, SEZs in some countries have a clear, positive impact, while those in others have a less positive or even negative impact. Raw survey data show political instability; poor business environment; limited access to infrastructure, finance, and utilities; and undue regulations are key obstacles in doing business inside SEZs.

Success factors and possible future directions

- **SEZs are not cost-free; with governance issues often behind failures.** Foregone tax revenues and the costs for providing infrastructure, land, and subsidized utilities should not be overlooked. Poor governance and oversight sometimes lead to rent-seeking and poor SEZ performance. However, these costs and failures do not overshadow the large economic potential SEZs offer, as seen by the many successful examples.

- **Successful SEZs have several common features.** These include (i) the fiscal incentives which are important for initial firm investments along with institutional factors—such as an independent SEZ governing authority and enabling legal framework—that prove to be a much greater draw over time; (ii) cheap factory sites, abundant labor supply, strategic location, and multimodal connectivity with resources and major trading destinations; (iii) institutional efficiency, dependable judicial systems, adequate security, and transparent standards; and (iv) strong state and local government commitment along with consistent policies.

- **SEZs should be an integral part of national development strategies to enhance their nationwide effect.** A clear link to an economy's development strategy increases the likelihood SEZs will have broad nationwide impact. They can become a major engine for national development through backward and forward linkages with the rest of the domestic economy. Thus, they offer significant opportunities for domestic participation, knowledge sharing, innovation, and skills development—supported by priorities defined by the economy's development strategy. This happened with SEZs in the PRC; the Republic of Korea; Malaysia; and Taipei,China. For many other SEZs in the region, while some are connected to global value chains, others remain largely enclave-type SEZs without the backward and forward domestic linkages and operate below capacity. These economies need to improve the business enabling environment and work toward moving up the industrial value chain.

- **SEZs can support services, a knowledge-based economy, and innovation.** For Asia's low- and lower middle-income economies, manufacturing may remain the staple for SEZs. However, even these economies—and those at higher income levels—must examine the potential of services, such as logistics, finance, information technology, and other business services. High technology and knowledge-based SEZs can combine with research and development centers, e-governance systems, and training and recreational centers to evolve into innovation clusters.

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How Can Special Economic Zones Catalyze Economic Development?

The Asian Economic Integration Report is an annual review of Asia's regional economic cooperation and integration. It covers the 48 regional members of the Asian Development Bank. This issue includes Special Chapter: How Can Special Economic Zones Catalyze Economic Development?

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to the majority of the world's poor. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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