**13**

# Visions of East Asia: Three Engines for a Way Forward

*Mari Pangestu*

It is ironic and challenging. Thirteen years after participating in the *East Asian Miracle* study (World Bank 1993), I am now being asked to envision the way forward for East Asia, the major development challenges the region faces, and the region's role in the global economy.

We have come a long way since then. First, there was the miracle, which was not really a miracle, but involved good policy and economic fundamentals such as high savings rates and macroeconomic stability. These still matter. Second, there was the Asian crisis, in which we learned that good policies were not enough and that institutions and governance mattered. Delivering on the types of reforms—policy and institutional—matters even more now as the East Asian economies become open economically and politically. Delivering these reforms while countries are undergoing the transition to democracy and, for some countries, such as Indonesia, a process of decentralization is a challenging task. Third, there was the rise of China and India, to which all East Asian economies and the rest of the world have had to adjust. The implications of their rise will continue, with consequences for competition, the way countries adjust, and the way the region carries on with the process of regional integration.

This essay is about these three trains of thoughts, the three engines for the way forward, and the three main drivers in each engine so that we may achieve an East Asian region that is prosperous and sustainable and plays an effective role in the world economy.

## Engine one: three poles are better than two poles

The rise of China and India has changed the constellation of the Asian region. China and India, which have abundant supplies of labor and large markets, have become two major poles of growth. Their demand for energy has an impact on energy and commodity prices and has changed the dynamics of trade and investment not merely in the region, but throughout the world, even as the prices of many manufactured products are falling because of these two large economies. Each of these countries is facing the pressures of rapid growth, including unbalanced and, sometimes, widening inequality. A large number of people are still living below the poverty line. The growth of these two countries will continue to pose challenges for the rest of the world, but especially countries that compete with them more directly. The rest of the world, including developed countries, will have to make adjustments. In the interim, there may yet be greater tensions because of more protectionism as countries seek to cope with the fresh competition. China and India will have to consider carefully the impact of their robust growth on the rest of the world.

In the years to come, Southeast Asia must develop into a third pole to rebalance the entire region. This is a challenge for the countries of Southeast Asian. How can this be achieved?

Each of the economies of the Association of Southeast Asian Nations (ASEAN) is at a different level of development. Singapore, on the one extreme, is already at an advanced level of development, but it must also look for new sources of growth by establishing niche sectors. It will continue to grow as a services-based economy. The relatively advanced countries of Malaysia and Thailand have a comparative advantage in export-oriented industries such as electronics, the automotive industry, and, to a lesser extent, textiles and clothing, and, of course, resource-based industries. However, they are also entering newer niche sectors. Indonesia is the largest Southeast Asian country. It has evolved out of crisis and is now in the process of economic recovery. Indonesia is much more richly endowed with natural resources than the other economies and has a comparative advantage in labor-intensive exports. It also will have to enhance value added and maintain its competitiveness. The Philippines has comparative advantages similar to those of other ASEAN countries, but the Philippines is an important exporter of labor services, and remittances are a major contributor to the country's foreign exchange reserves. Vietnam is no longer a transition economy; it has undergone rapid transformation in the last 10 years and is providing stiff competition to countries such as Indonesia. It is expected to become a member of the World Trade Organization in 2006. Cambodia became a member in 2004and has opened up its economy, but will need more institutional and infrastructure development to attract greater investments. The Lao People's Democratic Republic is still involved in a process of change. Myanmar has internal problems.

In essence, each of the ASEAN countries will have to raise productivity, find niches for specialization, and undertake reform to maintain competitiveness relative to China and also India. It is difficult to compete for large production volumes. Thus, it is best for these countries to undertake specialization, improve quality and design, and enhance the product range.

The ASEAN economies are also at various stages of political and institutional reform. At times, there are hiccups, and more serious problems delay the speed of change. The ASEAN economies must manage this process, with its ups and downs. China's process of political opening-up and institutional change also represents a challenge.

Inequality and the number of people living in poverty are much more severe problems in China and India than in Southeast Asia. Relative to China, Southeast Asia is also by and large ahead in the transition to political openness and democratic institutions.

Collectively, the population of Southeast Asia is close to 600 million. Average per capita incomes are high, and the resource base is rich. There is also a diverse system of production and service delivery. Thus, Southeast Asia could become, sooner rather than later, the third pole in an ASEAN community benefiting from social and economic security. At the moment, the target for achieving this is no later than 2020. The idea of establishing a regional production base and a regional market has been discussed since before the early 1990s when the ASEAN Free Trade Area (AFTA) was introduced. The program to accelerate economic integration through the ASEAN economic community entails addressing tariffs, but also bringing down nontariff barriers, harmonizing or mutually recognizing standards, facilitating trade such as through the creation of an ASEAN single window by 2008, and so on.

If the ASEAN economic community is to be a third pole that acts as a viable counterweight, these efforts must be accelerated. There must be sufficient political will to ensure that national policies are changed so that a single production base, a single market, support services, and infrastructure are developed properly. Southeast Asia views this as a way to compete and be perceived as the alternative pole to the two giant, emerging poles of China and India.

Benefiting from three poles that are developing synergistically, the East Asian region will enjoy relatively high rates of economic growth for years to come. While there will be competition, there are ample differences in terms of resources, sources of comparative advantage, and markets. Each pole will be attractive and distinct in its own right, but there will also be many areas of synergy.

## Engine two: policy matters; institutions and governance matter more

What worked during the East Asian miracle still works today. Stable macroeconomics, good policies, and strong economic fundamentals are still prerequisites.

However, delivering successes in second-generation reform, institutional change, governance, and corruption has become tough in East Asia. The process of expanding political openness and instituting the transition to more stable and mature democracy and the requisite institutions is an even greater challenge. Recent events in Thailand are an indication of the difficulties that will continue to be faced by Asian countries.

However, succeeding on these fronts will become a pathbreaking way forward. The question is clear: Might good policies coexist with bad politics?

In early 2004, in a newspaper column,[1] I wrote the following:

> Economists say “it’s politics, stupid,” whilst politicians say “it’s economics, stupid.”
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> At a recent seminar, a former central banker turned research economist turned top-ranking government official, Andrew Sheng, gave an interesting talk. It had a fancy title, but he indicated that the essence of his talk was the “confessions of a reformer turned bureaucrat.” The message was simple enough: both economists and politicians were right. That undertaking the necessary economic reforms and good governance would always be hit by political constraints, but that good politics at the end of the day had to deliver the goods. So the conclusion is that those in decision-making and leadership position should set realistic and achievable goals, prioritize two to three (or even one if the constraints are onerous) priorities, and really deliver on them.
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> After five years of ups and downs in reforms and dramatic political changes, with no clear light at the end of the tunnel, we in Indonesia have also come to the same realization. We have lowered our expectations to achieving all the reforms smoothly in reasonable period of time. Given institutional, capacity, and political constraints, we know [how] to set our sights at the priorities, set short-term goals that hopefully go toward the more ideal, longer-term framework that will bring the greatest benefit to the most people. So what [do] domestic and foreign investors and the average Indonesian want to see in this important year of change, 2004? What kind of president and what kind of government? We want real change, and, to us, this now means a credible start and an important signal that it is not going to be business as usual anymore. What are the priorities?

Little did I know when I wrote this column that we would have the first president directly elected, with 60 percent of the popular vote, whose vision involves making real change and providing a signal that it is not business as usual. I also had no inkling then that I would be in the category Andrew Sheng calls “reformer turned bureaucrat.”

Indonesia has undergone a dramatic transformation in the last eight years. But, I suppose, the basic messages listed above remain unaltered. Prior to the crisis, we went through a process of deregulation and opening the economy, but there was a lack of political openness. Then the economic crisis and collapse revealed the many weaknesses in the economy and in institutions. It took an economic collapse to bring democracy, showing how a nation can turn a crisis into an opportunity for historic change. And it will take economic development and prosperity to maintain democracy. It will take major transformations on various fronts to advance toward a mature and orderly democratic process, and it will take time. There must be a major change in institutions, including the legal, political, and state apparatus. Most importantly, the commitment must be made to address corruption and the problems in governance.

The government and those representing the government should lead by example in tackling the issue of good governance and corruption. The proper balance must be struck between the establishment of minute checks to weed out all corruption and more fundamental reforms. It would be difficult to tackle corruption without, for instance, addressing civil service reform. There are no magic bullets, and strengthening governance and combating corruption will take time. Thus, there has to be a long-term commitment. The key will be institutional reforms involving prioritization and sequencing.

Reflecting on the Indonesian experience in introducing change might lead one to propose the existence of three key pillars of activity in the effort to achieve institutional change and good governance and to address corruption.

*The first pillar: transforming institutions*

Transforming institutions will require strengthening political institutions through the use of a system of reasonable checks and balances. In turn, this will require strengthening the legislative and executive apparatus and instituting methods to enhance accountability in decision making. The ground must be prepared for informed policy decisions and for policy change.

One must collect the proper facts and accurate figures, undertake impact analysis, map out the losers and gainers from any policy change, and come up with a balanced proposal. Meanwhile, one is faced with the pressure exerted by various groups. Navigating among the competing interests is a challenge for the executive, which must make good decisions that will bring the most benefit to the people. Leadership today must produce informed policy decisions. At the top, but especially at the bottom, there must be a feeling of ownership and a willingness to accept many new ideas and policies despite the resistance. The socialization of any new idea or policy takes time, but it must be done. There are consultations. Compromises must be made for many reasons. Even in the case of a policy that is less than ideal, how does one make good compromises so that even this policy is not rendered ineffective? One must manage expectations, picking early winners so as to build a constituency for change, but also making clear that the full impact of some reforms will not be felt immediately.

There should be a sustained effort to strengthen the judiciary, build an effective public service, and manage decentralization. One should undertake civil service reform and create adequate institutional capacity in government ministries. This will be a long-term task. Civil service reform will include the installation of a merit-based system and an appropriate incentive and penalty system. This can occur only in stages. Short of reforming the entire public service, one has to begin by creating islands of excellence, applying methods to reduce the discretionary power of officials, enhancing transparency, and establishing a monitoring system.

Given the length of time administrative reforms will take, a leader must be able to find short-term measures that will signal the seriousness of his or her desire to change and advance the achievement of the longer-term goal.

The government of Indonesia has created islands of best practice within an imperfect system. For instance, a few years ago, the Ministry of Finance created the large taxpayers office. This office manages and administers the tax accounts of large taxpayers. It provides better service, and the officials receive better compensation. Their work is monitored closely. In my ministry, the Ministry of Trade, deregulation and greater transparency are being promoted. We have reviewed 77 regulations of the ministry. We have suppressed those deemed unnecessary, streamlined the requirements for the others and made them transparent, and determined the number of days and the cost of processing individual documents and licenses. All the relevant information is well posted for the benefit of the public. We are also beginning to introduce online systems for obtaining and filing applications so as to make the process more arms length. Of course, we have only now begun this process, and implementation must be closely monitored to ensure that it is effective. Meanwhile, we are also building up the capacity of other human resources and systems inside the ministry.

Another approach the government is currently developing involves special economic zones. These are areas where islands of excellence and islands of best practice would be created. The proposal is still being worked out, but the aim is to identify rapid, effective ways to establish hubs of economic development that would act as catalysts. These zones will not solicit greenfield investments, but will already include infrastructure and be able to provide access to inputs of production such as labor and supporting industries, clusters of industries, and sufficient area to expand. Most importantly, there will be a single, integrated zonal authority that will provide best practice in terms of services and systems to help investors. This will involve issuing the necessary local and national licenses and permits, supplying a service to assist in resolving problems, and providing efficient administrative support services such as for the customs, import and export procedures, and so on.

*The second pillar: providing a conducive business environment*

Providing a business-friendly environment has not been the premise of policy in the past. However, the way businesses operate must also change. Businesses that require preferential treatment or concessions to survive are not acceptable in this new era. Private sector leadership must operate within today’s different rules of engagement. Leadership and entrepreneurship that foster efficient, effective, and innovative Indonesian businesses must be developed alongside the improvements in public governance. Both private sector and public sector leadership must play a role in creating the proper understanding of conflict of interest and the correct interpretation of public-private partnership and incorporated in Indonesia.

*The third pillar: leadership at all levels*

It will not be possible to implement all these institutional changes and create best practices unless there is an accelerated program to upgrade human capital. The education, training, and development of a cadre of young people who will carry on the process will be crucial. For all three pillars, leadership is needed in the public sector, the political and legislative arena, the private sector, nonprofit organizations, the press, academia, and so on. Indonesia’s demographic structure is that of a relatively young population, and this represents opportunities and challenges. If we invest in the leadership of the next generation, we should not fear the future. A new, revitalized leadership will continue the process and secure Indonesia’s transformation and its place in the region.

It is incumbent on all institutions to take responsibility for investing in human resource development and capacity building so as to create the next generation of leadership. The process will take time, and we need continuity and consistency. Otherwise, the longer-term goals will not be achieved. That is why, in the Ministry of Trade, we have spent a lot of time thinking through the appropriate program for identifying, training, and building the capacity of the next generation of leaders in the ministry. There are constraints in the civil service regulations, but the government is also developing a program of administrative reforms that would facilitate breakthroughs in the system. A number of ministries, including the Ministry of Trade, are participating in the program.

## Engine three: regionalism to regionalization

In the 1970s and 1980s, the export-oriented strategies of the East Asian economies benefited from an open world trading system. From the mid-1980s onward, during the years of the Uruguay Round (1986–94), the East Asian economies undertook a process of unilateral reforms. This led to "regionalism," or market-driven regional integration. The unilateral opening-up by each country, including a policy of export orientation, whereby exporter-producers could access inputs at world prices, meant that a regional production base emerged. Intra–East Asian trade was a trade in components and parts; the final products were exported to third-country markets. The emergence of value chains reinforced these trends. China remains a center of gravity in regional production.

Is such regionalism sufficient, or must there be greater regionalization? Must there be more formal regional agreements to facilitate an even stronger East Asia. It is important that free trade areas (FTAs) encourage integration rather than fragmentation among markets. After all, FTAs are a means to foster market-driven forces. FTAs that do not facilitate market-driven forces only contribute to higher business costs and greater market fragmentation. For instance, discriminatory or cumbersome rules of origin are obstacles to the regional production base. One should be able to produce components and inputs based on specialization and competitiveness (not merely to satisfy rules of origin). In accomplishing this, one should bear in mind three principles so as to ensure that East Asia regionalization reflects best practice and facilitates rather than hinders market-driven forces.

### *The first principle: open regionalism*

Regionalism in Asia should not be an inward-looking, discriminatory arrangement. When ASEAN formed AFTA, this principle appeared to have been violated. However, ASEAN never meant to create an inward-oriented regional market or an internal ASEAN market.

ASEAN's trade is predominantly with non-ASEAN countries. ASEAN's main objective was to create a competitive regional economy that would attract global investors who would use the region as a production and export platform for global markets.

Nonetheless, the principle of open regionalism is manifest in ASEAN in the reduction of most favored nation tariffs in parallel with and, in some instances, more rapidly than the reduction in the common effective preferential tariffs of AFTA, as ASEAN deepens the economic integration process to achieve ASEAN goals.

The liberalization agenda of Asia-Pacific Economic Cooperation (APEC) is also based on this principle. Liberalization, that is, the removal of trade barriers, is undertaken unilaterally by each APEC member economy, but in a concerted manner. This modality is known as concerted unilateral liberalization.

Some question the efficacy of this modality. However, APEC is a nonbinding process.

Therefore, this modality is the only feasible one. If the process has not delivered on expectations, this may well be due to the weak peer process (pressure) that should be driving trade liberalization. Those who are unhappy with the results have demanded radical change in APEC's approach, and they have suggested turning APEC into a free trade area of Asia and the Pacific. This is contrary to the principle of open regionalism. In any case, the political feasibility of the proposal is highly problematic because the region is so diverse. It could well be that, because a regionwide FTA is almost impossible, countries have resorted to subregional and even bilateral arrangements. These have proliferated lately.

*The second principle: regional community building is more than trade liberalization*

Regional community building is a comprehensive undertaking. It must at least include these pillars of APEC: liberalization, facilitation, and development cooperation. In APEC, these key elements have been translated into the trade and investment liberalization and facilitation agenda and the economic and technical cooperation agenda. In the past few years, two other agenda items have been added, namely, human security and governance.

The focus remains largely on trade liberalization, however. APEC's progress is measured in terms of progress in its trade liberalization agenda. This is so because the goals of APEC community building have been narrowly defined as the achievement of free and open trade and investment in the region by 2010 for the developed economies and 2020 for the developing economies.

In ASEAN, the focus of economic cooperation is on the realization of AFTA, at the latest by 2015 (for some countries in the Cambodia-Lao PDR-Myanmar-Vietnam group and for certain agricultural commodities), while the goal of an ASEAN economic community by 2020 remains ill defined.

FTAs are now seen as the main manifestation of regional community building. They are being broadened to include investment, competition policy, and a number of behind-border issues. These more comprehensive agreements are called new age agreements, economic partnership agreements, or comprehensive economic cooperation agreements. In principle, they enshrine the three pillars of APEC, some more explicitly than others. For instance, the Japanese economic partnership agreement explicitly includes economic and technical cooperation.

The problem is that these agreements involve hard-nosed negotiations among participating economies about exchanging concessions. Confidence and community building are reduced to a bargaining game. Other aspects of cooperation have been overshadowed by this exercise in bargaining. This is not Asian community building through sharing, solidarity, and mutual support.

East Asia community building, which was proclaimed as an alternative to APEC community building because it does not involve countries such as the United States, is in danger of falling into the same trap as other regional initiatives. It is unable to get beyond forming an FTA to develop an institutional identity.

*The third principle: ASEAN should be at the center of regionalization in East Asia*

ASEAN should be a central part of the process of regionalization in East Asia. There is much discussion at the moment on who should be included in East Asia. In the ASEAN and dialogue-partner process, it has been taken to mean ASEAN, plus China, Japan, and the Republic of Korea (ASEAN+3). In last year's seminal East Asia Summit at the leaders level, it was taken also to include Australia, India, and New Zealand.

How should East Asia regionalization then evolve? One path that might be examined is the consolidation of various trade agreements in East Asia into a single FTA, which would then be linked with other parts of the world.

ASEAN has played a significant role in this. ASEAN leaders realize that strengthening intra-ASEAN cooperation and linking it to other parts of the world would maximize the potential for creating greater trade and investment opportunities.

Asia's economic integration is designed to be more thorough than a conventional FTA arrangement. ASEAN+3, for instance, is already committed to moving forward to greater monetary and financial cooperation. Regional monetary and financial cooperation would contribute to global financial stability. Greater monetary and exchange rate policy coordination would be especially beneficial to the highly export-oriented and deeply interdependent economies of East Asia.

In theory, ASEAN could play a significant role in maintaining coherence and consistency in all these initiatives because it is at center stage whether we are talking about ASEAN+3 or ASEAN+1 (ASEAN, plus China), which has already progressed to liberalization in goods; agreements have been signed with China and Korea. It seems that, even with greater East Asian economic integration, ASEAN will play the central role. It would be difficult to solve the leadership issue within a wider effort at economic integration in East Asia.

This is the main challenge for ASEAN, as well as for the region as a whole. The ASEAN economic community must be strengthened in reality, not merely in form. The acceleration in 11 priority sectors must be realized beyond the liberalization of trade in goods. This will require serious effort at removing nontariff barriers and accelerating trade facilitation. In trade facilitation, some progress has been achieved through mutual recognition agreements in two sectors, electronics and professional services.

For the customs, there is agreement on implementing an ASEAN single window by 2008. This requires each ASEAN country to build up a national single window. All documentation for the clearance of goods, including export and import documents and customs clearance documents, must be automated and linked to banking and shipping documents. The processes and documentation will be synchronized within all of ASEAN by 2008. The advantages are, of course, speed, greater accuracy, less discretion, less potential for underinvoicing and smuggling, and access to a more precise regional database on trade.

One could ask: Is this enough? Probably not, and ASEAN will thus still need to accelerate the process of broadening integration and to strengthen its efforts to create an ASEAN economic community, perhaps before the target date (2010 for the 11 sectors and 2020 for all sectors).

In the ASEAN+1 processes that are ongoing, we can see glimpses of potential ASEAN leadership. The main principles of the approach might be a good basis for general principles and for leading by example. These principles are as follows:

- Start with a comprehensive framework that includes goods, services, investment, nonborder issues, and economic and technical cooperation
- Sequentially, start with tariffs on goods and work on the remainder
- On the liberalization of tariffs on goods, the AFTA experience has been replicated by (1) ensuring substantial coverage, that is, 90 percent in the normal track and 10 percent in the

sensitive track; (2) realizing that elimination is the target, that is, zero tariff is the final target; and (3) establishing liberal and simple rules of origin (40 percent cumulative value added, AFTA rules of origin, with some changes in tariff headings or for some products)

This framework has been adopted in the case of the ASEAN-China and ASEAN-Korea FTA framework and in the FTA in goods components. It has also been used as the basis for negotiations with India, Japan, and Australia and New Zealand, where progress has been slow.

Of course, we still face the challenge of instituting best practices for the remaining components of the FTAs. If ASEAN is to pay a leadership role in this area, it must review the basic principles and ensure that it can also lead by example in these other areas.

## Notes

[1] *Jakarta Post*, January 2004.

## References

World Bank. 1993. *The East Asian Miracle: Economic Growth and Public Policy*. World Bank Policy Research Reports. New York: Oxford University Press.