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ADB Institute Discussion Paper No. 41

Building Blocks or Stumbling Blocks?
Regional Cooperation Arrangements in Southeast Asia

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This paper examines the inter-relationships between subregionalism, regionalism, and multilateralism using the Greater Mekong Subregion (GMS) and the ASEAN Free Trade Area (AFTA) as case studies. In particular, we look at whether subregionalism or regionalism can assist a country in moving towards multilateralism. We find that the GMS program is assisting its members to integrate more closely with the ASEAN region and, through this, with the rest of the world. As a program based on market rather than institutional integration, the GMS is promoting regionalism without hampering multilateralism. With regard to AFTA, if members pursue open regionalism and offer their trade and other preferences to nonmembers on a nondiscriminatory basis, then this is consistent with the objectives of multilateralism. For the original ASEAN members, AFTA has actually hastened the speed at which they have moved towards their goal of free trade because of the ambitious liberalization program it has committed them to. The newer ASEAN members should follow suit if they are going to maximize the benefits from liberalization and minimize the costs associated with trade diversion and trade, production, and investment deflection.

I. Introduction

The last two decades have witnessed a proliferation of formal regional trading arrangements (RTAs) mostly in the form of free trade areas (FTAs). There is strong demand to form or to join RTAs on political grounds. As Bhagwati (1997) puts it, "No politician is happy unless he has put his signature on at least one of them." There is also an apparently strong compulsion to avoid being an outsider on economic grounds.¹ As far back as 1964, Robert Mundell demonstrated how trading partners who do not join a preferential trading arrangement might be made worse off (through terms of trade effects)² even when global welfare is enhanced. Even in the absence of terms of trade effects, the fact that an outsider's competitors may have negotiated preferential access to its major markets suggests that the costs of not joining could be high. The threat of trade and investment diversion is viewed as a compelling reason to seek membership in RTAs (Lawrence 1996).

More recently, however, there has been significant interest in less formal arrangements sometimes referred to as growth triangles or quadrangles or more generally as subregionalism.³ Every member of the World Trade Organization (WTO) today is also a member of at least one subregional or regional cooperation arrangement, many are members of both, and some are even members of multiples of each. This is sometimes referred to as the "spaghetti bowl" effect (Bhagwati 1993).

In light of these developments, it is pertinent to ask the question, what are the inter-relationships between subregionalism, regionalism, and multilateralism? Apart from the inter-relationships, it is also interesting to consider the conditions under which subregionalism or regionalism can assist a country in moving towards multilateralism. Put a different way; is there anything that countries can do to ensure that their membership in subregional or regional cooperation arrangements will act as building rather than stumbling blocks towards free and open trade and investment? The relevance of this question is rooted in the fact that, in economic terms, preferential trade liberalization will always be inferior to nondiscriminatory or multilateral tariff reductions.⁴ Thus, if subregionalism or regionalism can help move a country towards multilateralism, then it is working in the right direction.

In answering these questions, we use the Greater Mekong Subregion (GMS) cooperation arrangement to represent subregionalism and the Association of Southeast

¹ As of 1994, all but 3 of the 128 members of the General Agreement on Trade and Tariffs were also members of at least one RTA (see Sampson 1996). Hong Kong, China; the People's Republic of China; Japan; and the Republic of Korea were the exceptions, but the latter two have negotiated bilateral trade agreements since then. If the Asia-Pacific Economic Cooperation initiative is included as an RTA, then there are no exceptions.

² This occurs when the preferential arrangement is large enough to affect world prices, and outsiders as a whole are harmed because their terms of trade deteriorate as a result of trade diversion.

³ There has also been a sharp increase in the number of bilateral trading arrangements of late, most of which are quite formal and comprehensive and as such are treated here like any other regional FTA.

⁴ As Cooper and Massell (1965) have shown, a nondiscriminatory tariff reduction will enable a country to enjoy trade creation without any trade diversion. Furthermore, the extent of trade creation under multilateral liberalization would be either equal to or greater than that possible within a preferential trading arrangement. The extent of trade creation under multilateral liberalization would be greater than that possible with preferential liberalization if the lowest-cost producer lies outside the grouping and would be equal to it if the lowest-cost producer were a member.

Asian Nations (ASEAN) Free Trade Area (AFTA) to represent regionalism. These choices are appropriate for our purpose because all countries in the GMS cooperation arrangement are also members of AFTA and are either already members of the WTO or are actively pursuing membership.

The paper is organized in 6 sections. Section 2 provides a brief overview of the GMS program and AFTA to set the stage for the ensuing analysis. In Section 3, we examine how subregionalism is affecting both regionalism and multilateralism. Next, we turn to the relationship between regionalism and multilateralism. One of the questions that we attempt to answer in this section is whether it is necessary to have "open regionalism" in order for the arrangement to be a building block towards multilateral principles and objectives. In other words, can multilateral objectives be achieved even without open regionalism? This question is relevant because some countries in the region have pursued open regionalism while others have been somewhat reluctant to do so. In Section 5, we look at what additional benefits WTO membership can bring to countries that are already members of both subregional and regional cooperation arrangements. A final section summarizes the main points.

II. The Greater Mekong Subregion Program and ASEAN Free Trade Area: An Overview

A. The GMS Program

The origins of the GMS can be traced to the 1957 establishment of the Mekong Committee, which then comprised the four riparian countries of the lower Mekong Basin. The region was, however, racked by conflict, so there was little cooperation over the following three decades. The process gained substance only in 1992 when ADB initiated a more organized program of cooperation among its members. The original members of the GMS were Cambodia, the Lao People's Democratic Republic (Lao PDR), Myanmar, Thailand, Viet Nam, and Yunnan Province of the People's Republic of China (PRC). In 2004, Guangxi Zhuang Autonomous Region of the PRC also joined the GMS.

The GMS program is a classic case of *market* as opposed to *institutional* integration. While institutional integration is characterized by legal agreements and institutional arrangements that promote preferential trade among members of the agreement, market integration relies on nonofficial institutions that provide public and quasi-public goods that reduce transaction costs associated with the international movement of goods, services, and other production factors (Cooper 1968; Garnaut and Drysdale 1994).

As a program of market-based integration, the GMS agenda has concentrated on the provision of physical infrastructure that has public good characteristics, e.g., cross-border infrastructure. Indeed, essential infrastructure of all types remains underdeveloped in most of the GMS economies, and the GMS program has focused on overcoming this constraint. Initiatives such as the east-west, north-south, and southern economic corridors are creating a network of roads that connect the region, reducing the cost of transporting goods and people from one corner of the region to the other.⁵ Options for interconnections for power transmission and the development of fiber optic transmission links—both covered through the GMS flagship programs on power and

⁵ For a recent analysis of the economic and social impacts of projects, see ADB (2005).

telecommunications—also fall within the geographic scope of these corridors. As argued by Mussa (2000), the role that transport and communication infrastructure plays in driving economic integration should not be under-estimated. In many ways, the reductions in transport and communication costs taking place in much of the Mekong region today parallel those that took place in the industrialized world decades ago.

Apart from “hardware” in the form of physical infrastructure, the GMS program has also tried to address complementary “software” issues. The facilitation of cross-border trade and investment is another key feature of increasing subregional economic integration in the GMS. The GMS program supports a range of measures to facilitate trade and investment that are designed to promote integration. These include improving procedures and transparency for customs clearance and enhancing technical skills to improve the application of various regulatory systems. Included in these efforts is the pilot testing of single-stop procedures of customs inspection at selected border sites. Research conducted by UNCTAD and cited in the Joint Study Group (2000) suggests that customs paperwork and procedures costs add up to about 7% of the global value of trade (see also Hertel *et al.*, 2001). This is likely to be an understatement of these costs in the case of the Mekong region given initial conditions, or the relatively poor state of such systems and procedures at present. The GMS program is also helping member economies prepare for a single GMS visa system. Besides promoting tourism and reducing the direct cost of cross-border control and management, a single-visa system would have indirect but positive effects on trade and investment.

The direct impact of interventions through the GMS program is already being reflected in trade and investment statistics for the subregion. Cross-border trade among the six GMS economies has increased sharply. For example, Thailand’s imports from its three neighboring countries, Lao PDR, Myanmar, and Cambodia has been increasing by an annual compound growth rate of almost 10% since 2000. More than two thirds of Lao PDR’s trade is with other GMS economies; more than a third is with Myanmar, and about a fourth is with Cambodia. In 2004, these three countries conducted more than 40% of their trade with each other. Nonetheless, a significant portion of trade among the GMS economies is not recorded. The nature of this type of trade makes it difficult to know its magnitude, but estimates range from about 30–50% or more of total recorded trade.

The trend is similar for intra-GMS net foreign direct investment (FDI) flows. Net FDI flows from the six GMS economies to Cambodia, Lao PDR, Myanmar, Thailand, and Viet Nam combined rose sharply from \$130 million in 2000 to about \$210 million in 2002, and estimates suggest that this growth trend has continued since. That trade and investment are growing hand-in-hand in the subregion is no coincidence. Early signs of a trade-investment nexus are emerging whereby trade not only encourages investment, but investment, in turn, encourages trade. This is a virtuous circle that links back to economic growth (Athukorala and Menon 1997).

B. AFTA

Although the origins of ASEAN date back to the early 1960s, it was officially launched in August 1967 as a result of the Bangkok Declaration. The original members were Indonesia, Malaysia, Philippines, Singapore, and Thailand. Brunei’s accession in 1984 brought the total membership to six nations. During its early phase, ASEAN

operated as a consensus-based, politico-security community with little attention paid to economic issues. On the economic front, ASEAN was dormant for its first 10 years.

The first attempt at promoting intra-ASEAN trade through institutional integration via regional trade preferences occurred at the Bali Summit in 1976 when ASEAN adopted preferential trading arrangements (PTA). Despite some initial promise and enthusiasm, the arrangements had little impact on intra-regional trade. In short, they were a failure. There were a number of reasons for this. First, the commodity coverage was narrow, and implementation was half-hearted. Second, the size of the proposed tariff cuts was too small to have any discernable effect on trade flows. On top of this, the PTA failed to deal adequately with non-tariff barriers, which were a greater impediment to trade than tariffs were (see Menon 1996 for a fuller discussion of these issues).

It took until the early 1990s before the next formal attempt was made to pursue intra-ASEAN trade liberalization. At the summit meeting of ASEAN heads of state in January 1992, the six agreed to establish AFTA by the year 2008. This deadline was subsequently moved forward to 2003. AFTA represents the most ambitious attempt at regional integration by ASEAN thus far. It is also the first political attempt to bring about regional free trade in Asia.

The centerpiece of the AFTA proposal is the common effective preference tariff (CEPT). It differs from the PTA in that its approach is essentially by sectors, making it more comprehensive and less cumbersome than the item-by-item approach of the PTA. The objective of the CEPT scheme is to lay the foundation for the creation of a single ASEAN market. Under the revised AFTA plan, tariffs were to be reduced to 20% within a time frame of 5–8 years (beginning in January 1993) before they were cut to 0–5% by the year 2003. This target has already been virtually realized for the six original members of ASEAN.

The first step in the widening of AFTA took place at the Fifth ASEAN Summit on 15 December 1995 when Viet Nam joined and acceded to the CEPT agreement. Lao PDR and Myanmar joined in 1997 while Cambodia came on board in 2000. For Viet Nam, the target date when 0–5% tariffs will apply to most intra-ASEAN trade is 2006. Lao PDR and Myanmar must adopt these tariff rates by 2008, and Cambodia by 2010.

Besides having tariff lines with strictly reciprocal preferences, the ASEAN integration system of preferences (AISP) was initiated to accelerate integration of the CLMV countries (Cambodia, Lao PDR, Myanmar and Viet Nam) into the regional market for trade in goods. At the 15th AFTA Council Ministerial Meeting in 2001, the original ASEAN members agreed to unilaterally extend tariff preferences to ASEAN's new members beginning 1 January 2002. This move is unprecedented for ASEAN, which has always operated on the basis of equal partnership. Although the AISP is implemented bilaterally and voluntarily, it is based on products that the CLMV countries themselves propose — not on those proposed by the providing countries. This provision was designed to avoid the so-called “snow-plow effect” whereby providing countries tend to extend preferences on tariff lines where there is little or no intra-regional trade.

III. Subregionalism: Impact on Regionalism and Multilateralism⁶

How is the subregionalism of the GMS program affecting regionalism and multilateralism? Are these intensive efforts at promoting subregionalism taking place at the expense of openness? We have already noted the rapid increase in intra-GMS trade and FDI flows, but is this running the risk of making the subregion more inward looking? The short answer is “no.”

As noted in Section 2.1, the GMS program is a classic case of market as opposed to institutional integration. There is no legal agreement prescribing preferential tariff concessions, so there is no potential for trade diversion as a result of the integration arrangement. Although there is no avenue for the textbook definition of trade diversion, is the GMS program giving its members an unfair advantage over nonmembers by making the movement of goods, services, and factors of production less costly inside the subregion compared with outside? In other words, is not an implicit subsidy to insiders just as bad as an explicit tax on outsiders? The short answer in this case is again “no.”

Although the hardware and software initiatives of the GMS program are mainly directed at promoting trade and investment, nothing in their design or application confines their impacts to the subregion. These public and quasi-public goods, once provided in or for the subregion, will also improve economic relations with the ASEAN region as a whole. In other words, subregionalism is driving regionalism because the way in which these *subregional public goods* are provided also enables them to operate as *regional public goods*.⁷

Emerging transport networks and economic corridors in the subregion are transforming its economic geography (ADB 2004). As connectivity between GMS countries improves, their linkage with the region as a whole is also enhanced. For example, when the economic corridors are completed, it should be technically feasible for goods to be transported by land from Singapore through Malaysia to anywhere in the subregion. Apart from physical connectivity, various legal and other software issues currently stand in the way of such a movement of goods. To address them and other related issues, trade and investment facilitation measures that are nondiscriminatory and WTO-consistent are being pursued subregionally. They complement measures AFTA is pursuing. Thus, directly or indirectly, countries outside the subregion will also have access to these initiatives and measures, so they will contribute on a general level to increased trade and investment. Thus not only can subregionalism be consistent with regionalism, but the former can also be a catalyst in driving progress with the latter.

On the other hand, what is the effect of subregionalism on multilateralism? Although the vast majority of positive spillover effects currently appear to be confined to the region, there are already signs that they are beginning to spread to outside countries. Over time, we should observe that subregional initiatives not only promote regionalism but also indirectly contribute to multilateralism as trade and investment increase globally. In other words, these subregional public goods can operate not only as regional public goods; they also have the potential to be global public goods. Consider the land-locked case of Lao PDR for instance. Without the economic corridors that provide road access to ports in neighboring countries, its exports to the rest of the world would be severely

⁶ Sections III and IV draw freely upon Menon (2005).

⁷ For a recent review of regional public goods, see Estevadeordal *et al.* (2005).

constrained by high transport costs. The same would be true for its imports from the rest of the world. In this way, connectivity through infrastructure development is reducing “natural protection” in a nondiscriminatory manner.

The GMS program itself provides a different kind of example of this phenomenon. It has helped its members become more effective members of ASEAN. This, in turn, will help them become more effective and visible members of the global community. These interrelations operate not only in terms of outcomes, however, but also in the process of moving toward these outcomes. For example, measures to facilitate subregional trade and investment complement many of the liberalization measures pursued as part of AFTA membership. This, in turn, helps some AFTA members prepare for WTO accession.

IV. Regionalism: Impact on Multilateralism

In this section, we examine how regionalism *a la* AFTA is affecting multilateralism. Unlike the GMS program of subregional cooperation, AFTA clearly falls within the textbook definition of institutional as opposed to market integration. In essence, AFTA is a preferential trading arrangement based on a legal agreement that prescribes tariff reductions on a purely discriminatory basis. It therefore has all the ingredients necessary for trade diversion and the potential to produce a classic second-best outcome where the welfare of even its members is reduced as a result. Necessary? Yes. Sufficient? No. Although AFTA members must extend trade preferences on a reciprocal basis and in accordance with a predetermined time frame, there is nothing that prevents members from voluntarily extending the same preferences to nonmembers. This is largely what the original ASEAN members have been doing by embracing the concept of “open regionalism” and thereby largely avoiding the second-best outcome.

A. Multilateralism through Open Regionalism

To minimize trade diversion, the original ASEAN members have been reducing their external tariffs, or tariffs applicable to non-ASEAN members, in conjunction with reductions on intra-ASEAN trade. This has minimized the margin of preference, or the difference between intra- and extra-ASEAN tariff rates, and thus minimized the potential for trade diversion. When preferences are fully multilateralized, the margin of preference is zero as is the potential for trade diversion. This was the case for more than two-thirds of the tariff lines for the original ASEAN countries in 2002 (see Feridhanusetyawan, 2005) and this continues to increase year by year. Furthermore, because the preferential tariff reduction schedules have been ambitious and rapid, AFTA has accelerated the pace of multilateral trade liberalization in the original ASEAN member countries. Instead of jeopardizing multilateralism, it has hastened the speed at which these countries have moved towards their goal of free and open trade. In this way, AFTA’s greatest achievement may have less to do with what it prescribes or mandates and more to do with what it promotes indirectly through the long-standing commitment of its members to the concept of open regionalism.

Figure 1 compares, in stylized form, trade liberalization outcomes under various scenarios involving WTO and AFTA. WTO negotiations and outcomes reduce the amount of time required for countries to move towards their goal of free and open trade

(defined here as 0-5% average tariff rates). How does AFTA affect this outcome? If AFTA is implemented on a purely minimalist basis, or without any multilateralization of tariff preferences, then the time taken to arrive at the aforementioned goal is unchanged. Average tariff rates do fall more rapidly however, particularly up to AFTA's 2003 deadline for 0-5% internal tariff rates, but this gain could be offset by the trade diversion that it would also induce. If, however, members choose to fully multilateralize their preferences for all tariff lines soon after AFTA's commencement, then the deadline for free and open trade is moved forward to coincide with AFTA's deadline of 2003. In reality, we observe that preferences for a majority of tariff lines have been fully multilateralized and if the remaining one-third or so of tariff lines are dealt with in the same way relatively soon, then the deadline will fall somewhere between 2003 and the WTO-based deadline. If this happens, AFTA would have served as a building block that enables countries to pursue multilateral goals at a faster pace.

Emulation of the approach taken by the original members would be in the interest of the Mekong economies. Indeed they will need to emulate this approach if they are not to be left behind, and if they are to succeed in deepening regional integration. Regionalism through ASEAN membership could then provide the GMS economies with an opportunity to pursue multilateralism aggressively and thus allow regionalism through AFTA to be a building block rather than stumbling block toward free and open trade. However, whether the worldwide proliferation of RTAs will eventually integrate rather than fragment the world economy remains a separate and open question.

There are reasons apart from minimizing trade diversion why the new member countries should emulate their predecessors in concurrently bringing down external tariffs. The freedom of members of an FTA to set their own barriers against trade with nonmembers raises the possibility of trade, production, and investment *deflection*. Trade deflection occurs when imports enter the FTA via the member country with the lowest tariff on nonmember trade. Trade deflection distorts the region's trading patterns with the rest of the world and deprives the member country that eventually consumes the import of tariff revenue. In the case of the GMS, revenue is likely to be lost to a member like Singapore, which is virtually a free-trade port.

Production deflection will occur if the manufacture of products containing imported inputs shifts to countries that have lower tariffs on the inputs because differences in tariffs outweigh differences in production costs. This is detrimental to economic efficiency and welfare since the pattern of productive activity will be based on differences in duties rather than on comparative advantage. The deflection of production may also affect the pattern of international investment. If differences in tariffs outweigh differences in production costs, tariffs will dictate investment decisions. Investment deflection will reinforce detrimental effects on welfare and efficiency associated with production deflection. Although the GMS economies may not currently be subject to much production or investment deflection because most are still not developed enough to compete with the other ASEAN members for the same types of investments, they could avoid it in the future by multilateralizing their AFTA tariff preferences.

To deal with potential trade, production, and investment deflection, AFTA imposes "domestic ASEAN content" requirements based on "rules of origin." These rules limit regional trade preferences to commodities that incorporate a minimum of 40% domestic ASEAN content. At best, application of these rules can only limit, but not eliminate, trade, production, and investment deflection in AFTA. Krueger (1995) goes further to

suggest that these rules can lead to the “export” of protection. This occurs when a member country deliberately purchases a higher-cost input from another member rather than the lower-cost alternative from a nonmember in order to satisfy rules of origin requirements and to gain duty-free access for its end-product exports.

Furthermore, rules of origin are notoriously difficult to police, and the administrative burden can be substantial. Not only is the origin of a product difficult to determine in this era of increasing internationalization of production, but the transaction costs resulting from the extensive documentation associated with this cumbersome process could nullify any benefits coming from freer intra-regional trade. In many of the GMS economies, the administrative costs associated with implementing rules of origin or measuring domestic content could be crippling.

Adoption of the nondiscriminatory approach to regionalism by the new member countries would maximize the extent and pace of their integration with the global economy. They could avoid trade diversion, as well as trade, production, and investment deflection. The new members could also do away with the tedious and costly tasks of implementing rules of origin and measuring domestic content of their imports. This would be the first-best option.

B. Multilateralism Even Without Open Regionalism?

A myriad of political economy considerations often stands in the way of first-best economic solutions. As Krugman (1993) puts it, preferential trading arrangements may have to be accepted, “...more or less grudgingly, as the best option in an age of diminished expectations.” This view may derive from the fact that the first-best option of nondiscriminatory trade liberalization may not always be politically feasible, or at least not immediately feasible, and that the second-best option is to liberalize trade within regional blocks. In some of the Mekong countries, concerns relating to the impact on government revenue and the competitiveness of domestic production appear to stand in the way of multilateral trade preferences (see Appendix 1).

In light of this, the question then is whether the pursuit of discriminatory regionalism necessarily implies that multilateralism will be impaired? This need not be so for the GMS economies in AFTA. Even if they chose not to multilateralize their preferences, regionalism can work in other ways as a vehicle to promote closer integration with the rest of the world. Even as a second-best option, regionalism through AFTA can help in the pursuit of multilateralism.

One avenue through which regionalism can promote multilateralism is through the strong links that the original ASEAN countries have with industrialized nations. Regional integration is bringing globalization to the doorstep of the Mekong through these links. Increasing integration with the original ASEAN countries will provide the GMS economies with a conduit to the outside world. Because the original ASEAN members conduct most of their trade extra-regionally and receive most of their FDI from non-ASEAN members, they have long-established links with the major industrialized countries. By integrating more closely with the original ASEAN members, the GMS economies will increase their opportunities for trade and investment with the rest of the world.

Indeed, the objective of establishing the ASEAN Economic Community (AEC) by 2020, a decision made at the 2003 Bali Summit, is to present this region of 530 million or so people to the global community as a single market and production base with a free flow of goods and services and relatively free flows of capital and labor. The AEC provides the GMS economies with a great opportunity to increase trade and investment with the outside world and to integrate more closely with the world economy.⁸

The strategic location of the GMS between the burgeoning economies of the PRC and India provides opportunities for integration beyond the region and presents a number of opportunities. The potential to boost trade, tourism, and investment is significant. Recognizing this potential, ASEAN leaders again confirmed their commitment to regionalism as a means to an end by signing framework agreements at the Bali Summit on comprehensive economic cooperation with both the PRC and India. These agreements will create free-trade areas between ASEAN and these countries.⁹

V. Multilateralism through the WTO

Some GMS economies are pursuing multilateralism directly and independently through WTO membership while others seek to join. Myanmar and Thailand have been members for some time, and Cambodia joined WTO in September 2003. The other GMS economies, Lao PDR and Viet Nam, are aggressively seeking membership.

In previous sections, we have argued that both subregionalism and regionalism can be consistent with the pursuit of multilateralism. More than that, and depending on the way in which countries go about it, both subregionalism and regionalism can actually contribute to multilateralism. If this is the case, what additional benefits, if any, will there be for members of subregional or regional cooperation arrangements in pursuing WTO membership?

WTO membership now will have less impact on Lao PDR and Viet Nam than it might have had prior to AFTA. Lao PDR conducts most of its trade with other ASEAN countries, so it already receives most favored nation (MFN) and national treatment (NT) status in these countries as a result of AFTA membership, which is what WTO membership, would have conferred. Lao PDR also already receives preferential treatment from many non-ASEAN trading partners, particularly the European Union. WTO membership will not affect that. With the recent granting of normal trade relation (NTR) status with the United States (US), Lao PDR is no longer the only Asian country

⁸ In the agreement that lays the foundation for AEC's establishment, ASEAN gave priority to integrating 11 industrial sectors: wood, rubber, automotive, textiles, electronics, agriculture, information technology, fisheries, health care, air travel, and tourism. Many of these sectors are important to the GMS economies.

⁹ Closer integration with the burgeoning economy of the PRC in particular, but also with India's, is widely acknowledged not only to present opportunities but also to create challenges. The PRC and India have large reserve pools of labor and thus have cost advantages in labor-intensive activities. With the scheduled end of the Multi-Fiber Agreement in 2005, both countries may be in a position to increase exports of textiles and clothing. Some of this could be at the expense of GMS economies. The GMS economies must eventually face the reality that the world's trading environment is changing in such a way that preferential treatment must eventually give way to comparative advantage. The challenge that this poses for the GMS is to restructure production to focus on activities in which they have a comparative cost advantage. The best trade policy environment to encourage specialization based on comparative advantage is one based on multilateralism.

to face punitive tariffs on its exports to that country. In short, many of the benefits that WTO membership would have delivered have already been realized through membership in AFTA.

Viet Nam has a comprehensive and wide-ranging bilateral trade agreement with the US and recently signed a trade and investment agreement with Japan that solidifies MFN and NT status for its trade and investment. The bilateral trade agreement with the US involves various commitments that will not only complement its push for WTO membership but will also fast track many of the benefits of that membership. In other words, the reform measures that Viet Nam is now implementing for the US bilateral agreement and the benefits that accrue from these measures plus the concessions that the US provides will lessen the net impact of WTO accession.

These are good things; they reaffirm the complementarities between regionalism and multilateralism. Perhaps the best illustration of this point is a comparison with the PRC's accession to WTO. The benefits are expected to be substantial, mainly because the PRC has long remained relatively closed and isolated from the global community, but unlike the PRC, years of liberalization and opening up associated with participation in subregional and regional initiatives means that a significant portion of the benefits have already accrued to countries like Lao PDR and Viet Nam. Thus, although WTO membership will unambiguously deliver net benefits to these countries, the benefits at this stage will be largely incremental.

Considering this, the most significant benefit to Lao PDR and to Viet Nam from WTO membership may well be a demonstration effect. WTO membership will signal to the rest of the trading world that these countries were able to meet a demanding set of international trade and investment rules and guidelines. The returns from strong demonstration effects should not be underestimated because they can have a significant impact on forging new trading relationships and attracting FDI.

VI. Summary and Conclusions

In this paper, we examined the inter-relationships between subregionalism, regionalism, and multilateralism using the GMS and AFTA as case studies. In particular, we looked at whether subregionalism or regionalism could assist a country in moving towards multilateralism. We found that the GMS program is assisting its members to integrate more closely with the ASEAN region and, through this, with the rest of the world. As a program based on market rather than institutional integration, the GMS is promoting both regionalism and multilateralism. The subregional public goods provided through the program are spilling over to become not only regional but also global.

Next we examined the relationship between regionalism and multilateralism. If members pursue open regionalism and offer their trade and other preferences to nonmembers on a nondiscriminatory basis, then this is consistent with the principles and objectives of multilateralism. For the original ASEAN members, it has actually hastened the speed at which these countries have moved towards their goal of free and open trade because of the ambitious liberalization program that AFTA has committed them to. The newer ASEAN members should follow suit if they are going to maximize the benefits from the overall liberalization program as well as minimize the costs associated with trade diversion and trade, production, and investment deflection.

Even if the newer members decide not to go this route, there are other ways in which regionalism is promoting multilateralism. Increasing integration with the original ASEAN countries will provide the GMS economies with a conduit to the outside world because the original members conduct most of their trade and investment extra-regionally. The strategic location of the GMS also provides opportunities for integration beyond the region. Location between the burgeoning economies of the PRC and India in particular presents great potential to boost trade, tourism, and investment. Finally, since both subregionalism and regionalism can actually contribute to multilateralism, is there still any basis for countries such as Lao PDR and Viet Nam to pursue WTO membership? The answer is still a definite yes, although the net impact will now be necessarily smaller given the benefits that subregionalism and regionalism have delivered. Perhaps the most significant benefit to Lao PDR and Viet Nam from WTO membership may now be in the form of demonstration effects.

Appendix 1

Concerns over Open Regionalism: Competitive and Revenue Effects

Some major concerns of the GMS economies about multilateralizing tariff preferences relate to perceived negative impacts on domestic production and government tariff revenue collection. The fear for domestic production is that if liberalization were to proceed multilaterally rather than regionally, a flood of imports might wipe out some industries. It is often argued that a number of industries in the transitional economies of the GMS are infant industries requiring protection for survival, but this issue relates to protectionism, not to whether liberalization should be preferential or multilateral once the decision has been made to liberalize. If grounds for protection based on the infant industry argument are valid, then such an industry should be quarantined from both preferential and multilateral liberalization until it has developed sufficiently to survive without protection. AFTA provides for a more gradual phasing in of tariff reductions for such industries by allowing them to be placed on the temporary exclusion and sensitive lists. For other industries, there is no reason to fear multilateral liberalization; on the contrary, it ensures that consumer welfare is maximized by enabling imports to be sourced internationally from the lowest-cost producer. So multilateralizing preferences should not jeopardize production of so-called sensitive industries in these economies because all that is being recommended is uniformity in provision of tariff reductions to all trading partners with no change in the time frame of liberalization schedules or in the range of products covered.

Another major concern about multilateral tariff reductions is that they might further erode revenue from trade taxes associated with AFTA-based trade liberalization. In other words, it is expected that a two-tier tariff rate—a CEPT rate for the intra-ASEAN producer and a higher MFN rate for extra-ASEAN producers—will mitigate total revenue loss somewhat. A significant difference between the two rates would, however, create a strong incentive for trade deflection. This would simply result in revenue being lost altogether to the member country with the lowest external tariff, which in this case is most likely Singapore. In short, if trade deflection occurs as a result of the dual tariff system, then tariff revenue collected by the importing country could actually be lower than if the tariff reductions were multilateral.

Apart from this, maintaining a system whereby two rates apply to each (if not most) tariff lines also increases the potential for rent-seeking behavior. It is an open secret that some portion of revenue associated with trade taxes is collected privately rather than publicly. This is reflected in the high estimates of the share of informal cross-border trade in the GMS. A higher MFN rate compared with the CEPT rate will provide a new avenue through which private rents are extracted with little or no change to public customs revenue collection. Indeed, reducing tariffs would remove some of the incentive for smuggling thereby increasing the share of total trade subject to tariffs. For these reasons, concerns about potential revenue loss should not stand in the way of these economies multilateralizing their CEPT tariffs and offering them to all trading partners on a nondiscriminatory MFN basis.

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FIGURE 1: WTO and AFTA Liberalization; Different Scenarios

