



# Economic Premise

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## Asia and South America: A Quasi-Common Economy Approach

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*The Asian style of regional integration may be seen as a “quasi-common economy” that eschews a formal linkup in political or monetary terms, but manages to generate similar results by strong physical integration and distributed chains of production and service delivery. This note proposes the Asian quasi-common economy as a benchmark for South America’s regional integration efforts because it is a better fit than the politically driven, broad-based, European style integrative process.*

Regional economic integration takes place as a combined result of decentralized, market-driven processes and politically driven institution building or adaptation. But the leader-follower relationship between these two spheres may differ: economic integration experiences in Europe and Asia provide two contrasting examples.

An illustrative example of the leadership of political will in Europe was at the time when the last steps toward the creation of the euro were made and there was widespread consensus among economists that conditions for an “optimum currency area” were far from prevailing. The response by euro proponents was that those conditions would develop endogenously after an integrative push led by institutional change and monetary unification, building upon what had already been obtained during previous stages of the European Common Market.<sup>1</sup>

One may point out an opposite leadership relation in the Asian experience—which this note refers to as a quasi-common economy (QCE). Trade and investments came first, with the build up of regional production networks preceding any concerted effort of major multilateral institutional adaptation at the regional level. Investments in infrastructure and the removal of potential stumbling blocks to market integration facilitat-

ed the integration of production processes, and talks and negotiations on institutional harmonization came later, after economic links were established.<sup>2</sup>

South American regional integration experiences have fallen far short of the levels of trade and macroeconomic interdependence achieved in Asia and Europe. Neither multilateral diplomatic efforts nor market-driven dynamics yielded expected results in terms of economic integration.

This note has a twofold objective. First, it approaches the Asian style of regional integration as a QCE that eschews a formal linkup in political or monetary terms, but manages to generate similar results by strong physical integration and distributed chains of production and service delivery. The central point of this model is the role of massive infrastructure ties and consequently easier mobility of stages of production lines across borders, allowing for the creation of one monolith economy devoid of formal setups. Secondly, this note proposes that using the Asian QCE as a benchmark for South America’s regional integration efforts is a better fit than the politically driven, broad-based European style. Despite the idiosyncratic geographic, political, and economic features of Asia and South America, there are lessons that South America can learn from

Asia's sequencing pattern. In Asia, physical infrastructure investments and intraregional trade facilitation created an environment conducive to business-driven economic integration. Broader institutional convergence has been pursued only to the extent that a concrete base of economic interests was there to support it. Compared to "big bang" approaches and correspondingly high requisites in terms of political capital and complex diplomatic negotiations, like those in Europe, the amount of political capital necessary in the Asian QCE was kept to a minimum. This note recommends that South American governments spend political capital on front-loading cross-border infrastructure investments that are accompanied by infrastructure project-specific trade facilitation measures, rather than on complex, detailed, treaty-like negotiations before the emergence of corresponding economic ties. A quasi-common market approach in South America may lead to better results than attempts at emulating the European path.<sup>3</sup>

### Asia as a QCE

A QCE is defined here as a regional economy with a high level of physical integration, minimal barriers to intraregional trade, interlinked and interdependent production structures, and no formal or centralized structure for coordination of an entire region's economic policies. The basis for such a postulation is that manufacturing and service sectors that are broadly integrated across countries have ramifications for wider economic policy regimes, which result from major transmission channels such as: (i) alignment of business cycles; (ii) mobility of factors of production; and (iii) economies of scale.<sup>4</sup> These channels in turn are a result of distributed production and supply chains predicated on physical integration. No grand institutionalized formal setups for lowering policy barriers to regional trade or other types of deep policy and regulatory harmonization constitute an ex ante condition, but more focused project-specific trade facilitation measures may be adopted. Although not required, the existence of free trade agreements (FTAs)—not necessarily customs unions or monetary unification—may amplify the results obtained in a QCE, as witnessed when the Association of Southeast Asian Nations and other China-centric FTAs were implemented in Asia.

A QCE is predicated on the following hypothesis: infrastructure or the level of public capital within a region's economies affects the growth or economic output via two channels. The first channel is the conventional and much discussed impact of public capital as a factor of production entering the national production function in addition to private capital and labor. The second and less highlighted transmission channel constitutes the heightened factor and goods mobility within the region that allows the setup of distributed production and delivery systems. Such a setup in turn aligns business cycles in the regional economies, converging input prices and wages by moving industries across borders to areas with competitive advan-

tage, and so fulfils Mundell's criteria through a backdoor. Thus, higher levels of public investment combined with lower barriers to trade may generate outcomes that are far more extensive than proximate effects upon individual outputs of the economies.

The rise of the Asian QCE was neither abrupt nor micro-planned. Factors such as advantageous first nature geography,<sup>5</sup> technological diffusion by the private sector, an export-led growth model, and openness of the economies aided the emergence of the QCE. The influence of manufacturing and liberalization started from the eastern most frontier of Japan, and in the 1970s, the influence crept over the Republic of Korea, Taiwan, China, and Southeast Asia. China came under the wave in 1980s, and India finally caught up in the 1990s.

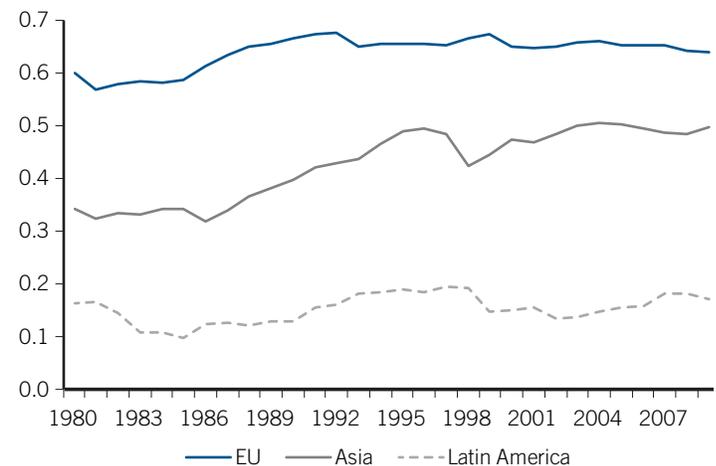
There are five defining features and results of an Asian style QCE:<sup>6</sup>

**High internal trade intensity:** High internal trade intensity is an indicator of the extent of integration<sup>7</sup> in a region. Further, it constitutes an important source of demand for member economies that may be extraneous to demand from other regions (Yeats 1998).

Using the European Union (EU) as a benchmark for comparing the export intensities of Asia and Latin America, the Asian economy has increasingly trended toward near-EU levels of intraregional exports (figure 1). Inversely, the Latin American intraregional export intensity has remained more or less constant throughout the 29-year period beginning in 1980. The Asian trend has come to mimic the EU trend, with a progressive closing of the gap between the two. It must be kept in mind that while the EU has achieved such high levels of intraregional trade, to a large extent it has been through a formal framework and administrative body; the Asian region remains a loose confederation of FTAs and distributed production chains.

**Distributed manufacturing and supply chains:** A key factor in the rise of Asian manufacturing and trade prowess has been

Figure 1. Ratio of Intraregional Exports to Total Exports



Source: UN Comtrade database.

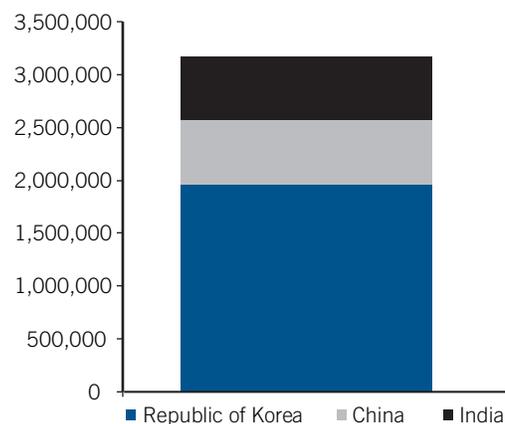
the evolution of a “flying geese” (FG) process (Akamatsu 1962) of structural changes in the economies. The rise and spread of the FG manufacturing hypothesis in the 1960–70s includes the following key trends: (i) migration of industries across borders to capitalize on competitiveness; (ii) domino industrialization or increase of growth rates in follower economies; and (iii) large investments by a leading goose country aiding growth rates in follower countries (Amsden 1991). The FG process of industries migrating across borders has created a distributed regional manufacturing and supply chain. This chain constitutes a cross-border production network that is spread across different countries, but tends to bestow an advantage similar to that of integrated regions or large countries with no internal trade barriers.

Figure 2 presents Hyundai Motor Corporation as a typical example of interconnected private sector manufacturing in Asia. Hyundai started exporting cars to developed countries in the 1980s, and they were competitive in making small, economical cars. Over the years, strong economic growth and rising wage levels boosted the costs of production, thus creating a comparative disadvantage in labor-cost-sensitive segments of small car production. Because of a third wave of FG development, Hyundai invested in countries with lower costs of production. The creation of 37 percent of total installed capacity in China and India allowed Hyundai exports to retain competitiveness and production numbers.

The figure 3 shows the bilateral import network comprising the Asian FG manufacturing supply chain. Extensive trade links predicated on physical integration have led to trade and production integration. In figure 3, the convergent setting of trade ports and production centers in Asia is hard to miss.

Such intraregional migration of industries from countries ahead in the development curve to those behind is a peculiar characteristic of the Asian QCE. The electronics industry played a huge role in the export buoyancy of Asia. The FG process of manufacturing development saw late industrializing countries such as Korea, Singapore, and Taiwan, China “learn-

**Figure 2. Hyundai Motor Corporation: Installed Production Capacity**



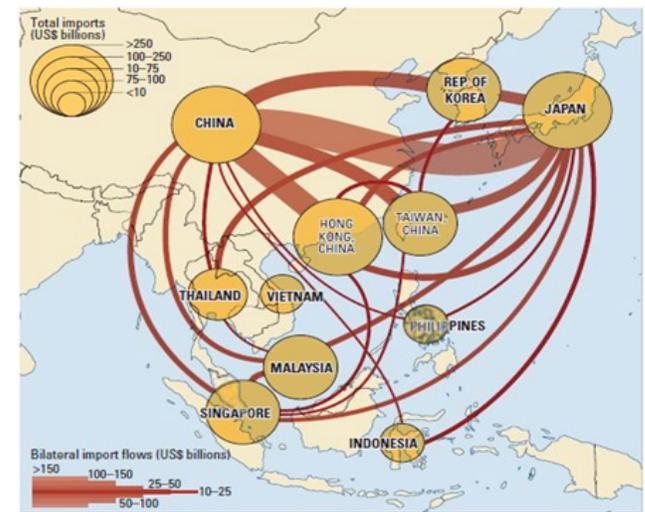
Source: Hyundai Motor Corporation Web site.

ing” technologies to produce value-added manufactures (Amsden 1991). The technological diffusion resulting from foreign direct investment (FDI), subcontracting, technology transfer, and trade led to a shift from input-sensitive industries to poorer countries in the region, even though productivity remained high in early industrializing countries.<sup>8</sup>

**Enhanced value-added exports:** Large integrated regions tend to export more value-added exports because of economies of scale and synergies between constituent units (UN-ECLAC 2005, 84). Figure 4 maps the data of value-added exports as a percentage of total exports for Asia, the EU, and Latin America.<sup>9</sup> Asian value-added exports, as a percentage of total exports, have remained even higher than EU exports. Latin American value-added exports started off from a very low base of only 25 percent and managed a convergent trend with Asia and EU exports, but peaked at 67 percent in 2000. The decline in value-added exports from Latin America is partially because of the base effect of the rise in commodity prices all over the world. As a region, however, Asia has overall tended to mimic, and in this case exceed, the performance of the EU, which is a formally integrated region.

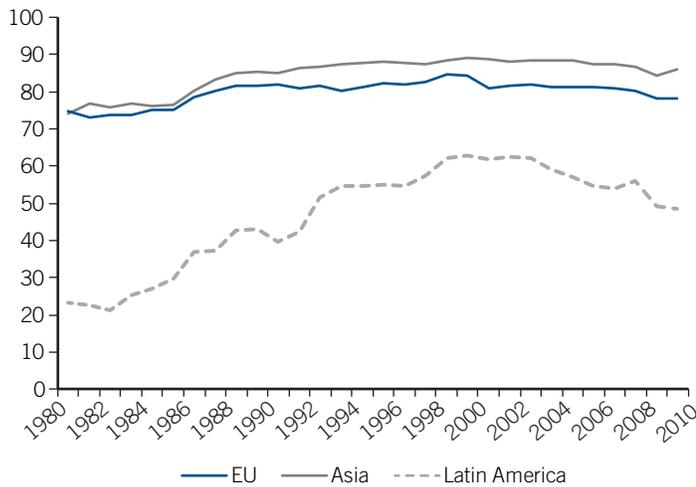
Conditions in Asia are favorable for the evolution of a QCE. As shown in the maps in figures 5 and 6, the production and resource endowment areas of Asia<sup>10</sup> are arranged in a convergent radial pattern. This natural arrangement allows Asia to set up closely located ports and production centers that can become links in a vast chain of production and service delivery. In fact, first nature geography is significantly correlated to economic output. As noted in the World Bank’s *World Development Report 2009*: “a simple regression of output density (GDP per square kilometer) on geographic variables—mean annual temperature, mean annual precipitation, mean elevation, terrain ‘roughness,’ soil categories, and distance from coastline—captures 91 percent of variability in the density of economic production.”

**Figure 3. Asian FG Manufacturing Supply Chain**



Source: Gill and Kharas 2007.

**Figure 4. Value-Added Exports as a Proportion of Total Exports**



Source: Authors' calculations based on UN Comtrade database.

Despite the significance of the first nature geography in deciding proximate growth differences, it is by no means a definitive factor. Unfavorable endowments or patterns of endowments—as far as physical integration is concerned—can be at least partially reversed by investments, although implying higher costs at the margin.

**Lower macroeconomic volatility:** A QCE setup also coincides with—or requires—stable growth and an externally stable economy. Table 1 contains the variance of growth figures for the EU, Asia, and Latin America. The growth variance for the EU and Asia stands at 3.3 and 3.9, respectively, during 1980–2009, whereas for Latin America the growth variance stands at 5.4. Similarly, the Asian QCE zone has performed better than Latin America on reference points such as external debt and inflation, which are indicators of stability on external and internal fronts for the respective economies.

There is no claim here of causality in the sense that building a QCE leads to lower growth volatility, and rather the stronger causality is most likely in the reverse direction. Macroeconomic volatility depends on factors far beyond the QCE. Furthermore, business integration and value chains can only flourish if neighbor countries do not frequently generate macroeconomic shocks to each other. But there is a feedback loop effect as the

**Table 1. Variance of Growth Figures, 1980–2009**

Region	Variance of growth	Variance of external debt	Variance of inflation
European Union	3.3	..	0.6
Asia	3.9	35.4	12.4
Latin America and Caribbean	5.4	75.0	13,664.3

Source: World Economic Outlook 2010.

Note: .. = not calculated.

commonality of shocks—and thus the convergence of macroeconomic policy responses—rises as businesses integrate among economies.

**Unrestrictive union:** A QCE setup allows regional members to retain their fiscal and monetary autonomy, thus allowing them some leeway in case of economic or financial contingencies. The inflexibility of a monetary union or the political difficulties of a fiscal union do not exist within a setup defined as a QCE. Because the endogeneity of macroeconomic convergence only takes place gradually, such rigidity may become a burden to the integration process.<sup>11</sup>

### QCE: Suitable for South America?

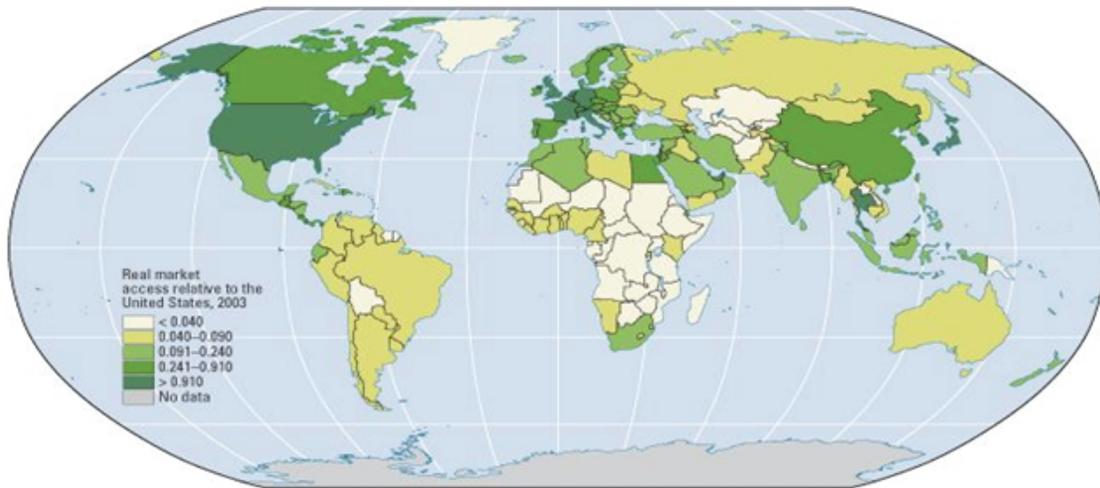
Is the South America region better suited to a QCE approach than ambitious, top-down, full-fledged economic unions? Because South America has never experienced the previously booming production network–driven integration of Asia, one cannot expect any linear and grandiose process of institutional reshuffle and convergence in the region. On the contrary, the recent past has included the tendency to experiment with different institutional designs and styles of public-private relationships.

In fact, regional integration within subregions and subsectors of the South American economy has been attempted with varying degrees of success for the past 60–70 years (UNECLAC 2005). The common grounds have tended to shift over time, with industrialization, external debt, trade, and the financial crisis occupying the minds of policy makers from time to time. But the big bang institutional approach has been a pet scheme of some policy makers, while one possible interpretation of the lack of meaningful results may be that political and economic realities were not strong enough to incentivize a long and risky venture into formal integration. From this perspective, a QCE approach would be the best path to pursue.

Traditionally, South America's economic fortunes have been heavily predicated upon the prices of international primary export commodities (IMF 2010; Canuto and Giugale 2010). The recent increase in the importance of the trade with Asia in general and with China in particular reinforces the role of the region as a commodities exporter.

However, as shown by the recent global crisis, diversification of exports can operate as insurance against volatility (Canuto, Haddad, and Hansen 2010; Haddad, Lim, and Saborowski 2010). Diversification offers a way of buying the benefits of openness while managing the downside risks. A higher degree of export concentration implies a greater impact of a price shock on the country's terms of trade, inducing greater fluctuations in a country's growth process. There is thus a strong need for most South American countries to diversify beyond unprocessed primary goods. The point here is that such a situation may be more easily reached if the region becomes an interconnected monolith and benefits from the scale and scope econo-

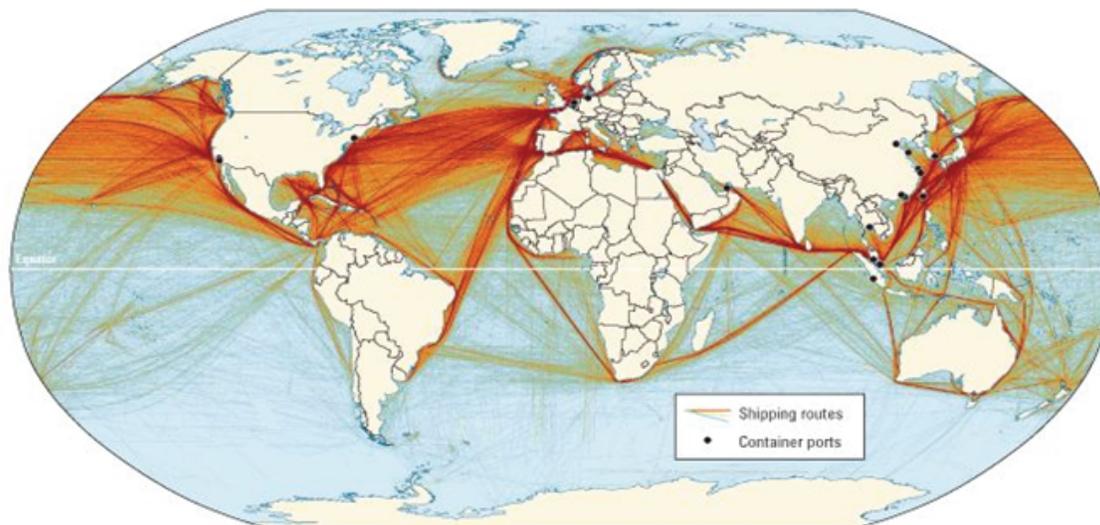
**Figure 5. Density, Distance, and Division Combine to Determine Access to Markets**



Source: World Bank 2009.

Note: To compute potential market access, each country is assigned a score for the size of its own market (real GDP) and the size of international markets with which it can trade. This is computed by weighting the GDP of other countries by the inverse of a measure of that combines physical distance, transport costs, and barriers to trade to show how difficult it is to access these markets. The measure, which is expressed relative to the market access of the United States, essentially combines all three spatial dimensions of density, distance, and division into a composite of potential market access.

**Figure 6. Busy Seafaring in the North, Little Landfall in the South: Intensity of Shipping Routes (October 2004 through September 2005)**



Source: World Bank 2009.

Note: Container ports shown are the 20 largest by TEU of local containers handled in 2005.

mies made possible by integration. Thus regional integration with a high degree of physical integration is a potential driver for breaking dependence from primary exports.

South America is composed of countries with wide disparities in income and stages of development. Such a heterogeneous composition of regions and countries can be easily exploited by utilizing comparative advantage leverage. Countries with comparatively higher per capita income such as Brazil, Argentina, and Chile will find themselves uncompetitive in some labor-intensive industries in the future. Thus a distributed supply and manufacturing chain will enable the region to optimize the

use of its capabilities, resources, and potential. The requirements to exploit productive complementarities stem less from absolute differences or gaps of income or capacity between economies in the region and more from the sectors of cooperation and the industries concerned. Sectoral economics dictating, some sectors of the economy may be more sensitive to capital or labor inputs respectively, and therefore a “no-one-size-fits-all” rule of thumb can be recommended in terms of income or capacity thresholds.

Finally, the idea of a physical integration–led regional integration is much more palatable from a political economy point of

view. Since there is no involvement of national political commitments or surrender of powers, it is far easier to set up and to receive political support, which suits the complicated political landscape of South America. Furthermore, diplomatically ambitious efforts may come to halt because of opposition around sensitive industries, while other sectors may support integration, which can be achieved more selectively in the QCE approach.

## Policy Conclusions

Using the Asian style as a template, the following sections include the policy conclusions for regional integration in South America.

### Physical integration

South America needs to significantly expand its infrastructure spending and make up for lost productivity and growth (UNECLAC 2009). Asian economies started stepping up their infrastructure investment on the back of buoyant revenues and growth in the 1980s. To exploit the positive externalities of the global supply chain-based production networks in the region, South America needs to create an infrastructure that can support and scale up the intense economic activities that constitute firms' modern delivery model. Benefits from catching up in infrastructure may be increased if it also paves the way toward deeper regional integration.

The Asian production arc stretches from peninsular India through Southeast Asia and China to northern Japan and is arranged in a convergent setting with most major ports close by. In South America, the coasts of the major economies do not face each other and the mainlands are separated by mountain ranges or forests. There are, however, already mapped possibilities that can be pursued (Canuto 2008). This is a field in which multilateral development institutions have been playing a fruitful and supportive role. The Initiative for the Integration of Regional Infrastructure in South America (IIRSA) is a dialogue forum among South American countries that benefits from the technical and financial support of the Inter-American Development Bank, in conjunction with CAF (Corporación Andina de Fomento) and FONPLATA (Fund of Plata Basin), and which has already generated a dense map of physical integration opportunities (see figure 2 and links in Canuto [2008]). Since the beginning of IIRSA, the 12 South American countries have identified a portfolio of multisectoral projects in transport, energy and communication, with a significant focus on implementation of transportation sector integration projects.

### Identify sectors or industries of cooperation rather than institutions

The Asian style regional integration process identified and explored specific industrial sectors, such as electronics, garments and automotive parts, for the mutual benefit of partnering nations. This bottom-up approach involved the addition of new countries or late industrializers to the supply chains of one in-

dustry and the creation of an entire cross-border ecosystem stretching across the region. Such private production networks have had a benign effect on wider economic policy, as discussed earlier in this note. Hence, it is highly appropriate for South American policy makers to shift their focus from creating multiple subregional bodies to identifying sectoral cooperation opportunities.

### Increasing interoperability within the region

Factors of production such as capital and labor should be granted higher mobility, such as enhanced engagement by member states to implement measures including mutual recognition of professional degrees, portability of social security, laxer border controls, scaling up of best practices across the region, and increased financial engagement of the regional financial systems.

Further, the private sector, which forms the bedrock of Asian style regional integration, needs to be accorded similar privileges throughout the region, or at least fostered to set up production chains throughout the region. For example in Asia, Honda has plants that manufacture gearboxes in China, axles in Thailand, and body shells in Japan. Similar supply and production chains need to be actively encouraged and promoted across South America.

### Addressing regional asymmetry

South America is a diverse region and needs to address the problem of asymmetric development levels among its member states. For a QCE model to address this issue, areas of complementarities need to be specifically identified and economic opportunities need to be leveraged from those. Specifically, the wage gap between richer and poorer member states can prove to be an effective leverage for the private sector and the regional economy to remain competitive in global markets.

### Technological diffusion

South American economies with relatively higher levels of technological accomplishment should pass on their legacy under technology transfer agreements. Similarly, current technologies should be used to generate contract manufacturing supply chains, such as in the electronics industry in Asia, where firms like Sony, Samsung and Foxconn, belonging respectively to Japan, Korea and Taiwan, China, have managed to exploit lower costs in China to produce their latest and best products in another country.

High investments in public infrastructure, formal economic unions or regional integration bodies, lower trade barriers, and geographic advantages have all been separately appointed in the literature as drivers of regional economic integration. This note tries to bring it all together under one tent by pointing out the example of Asian integration, which has yielded advantages like high internal trade intensity, distributed manufacturing and supply chains, regional economic stability, enhanced value-added exports, and technological diffusion. All of these advantages were delivered under an informal economic

union that utilized first nature geographic advantages to generate a physically integrated economy.

A major barrier that could prevent South America from following a similar path is the lack of physical integration in the economy, as well as the absence of a more pragmatic and modest trade facilitation agenda. Focusing on these two fronts is likely a more promising approach than the alternative European-like all-encompassing agenda.

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Otaviano Canuto is the *Vice-President for Poverty Reduction and Economic Management (PREM)* and Manu Sharma is a *Junior Professional Associate* at the World Bank. The authors would like to thank Bernard Hoekman, Mona Haddad, and Jose Guilherme Reis, all from the *International Trade Department in PREM*, for invaluable comments to a draft version of this note.

## Endnotes

1. Robert Mundell (1961) originally referred to the symmetry of shocks among members, labor mobility, and fiscal policy centralization as preconditions for an optimum currency area. Frankel and Rose (1998) highlighted the endogeneity of foreign trade patterns and cross-country business cycle correlations.
2. Amsden (1991) and Canuto (1994) provide earlier accounts of the emergence of regional production networks.
3. It is important to acknowledge that geography helps explain the different paths of the two regions. East Asia is connected by a sea, whereas the Latin America and Caribbean region includes a big land mass with major mountains and limited natural connectivity. History also matters; in East Asia, trade relationships go back millennia. The argument here is not for an impossible emulation of such geographical-historical idiosyncratic experiences, but on approaches to economic integration.
4. See Kose, Prasad, and Terrones (2003) and World Bank (2009). Recall in this context how standard trade theory has already demonstrated that increased (intra-regional) trade may partially substitute for labor mobility.
5. First nature geography is a term used to define the spatial disparities in distribution and allocation of natural resources (see World Bank [2009]).
6. For the sake of illustrating regional differences, we here compare Asia to the broader Latin America and Caribbean region.
7. See <http://aric.adb.org/indicator.php>.
8. The process of industrial diffusion from richer to poorer parts of the regional economy has been pursued by the late joining eastern members of the EU—especially Poland and Romania.
9. Defined as ratio of exports in Standard International Trade Classification categories 5, 6, 7 and 8, and total exports with the world for respective regions.

10. Defined as East Asia and South Asia taken together.

11. An obvious example has been the difficulty in formulating policy responses to the crisis in the EU. The rigidity of the monetary union is clashing with the divergent range of preferred national policy choices under current circumstances, as noted by most analysts.

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