

Preliminary draft (for discussion)

Towards an Asian Economic Community

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1. Introduction

The birth of the WTO in 1995 was meant to herald an era of multilateral cooperation in trade liberalization. However, over the years, the many limitations of the WTO process have come to light. For instance, the positive list approach to trade liberalization and the time taken in negotiations for market access have forced countries to seek other methods of trade liberalization. It is in this environment that Regional Trading Agreements (RTAs) have taken on an increasing significance. In RTAs, negative list approach for trade liberalization have been more commonly used and the smaller number of members has facilitated effective dialog and consensus. Furthermore, as the protests in Seattle are testament to, WTO negotiations have often been not very favourable to developing nations, and therefore many of these countries took steps to conduct trade and development work at a regional level.

This proliferation of RTAs has resulted in a significant level of trade concentration in RTAs. Two of the largest RTAs are NAFTA (North American Free Trade Area) and the Single European Market. In the EU, intra-regional trade was as high as 60% in 1996 and NAFTA had 47% intra-regional trade at the same time. Similarly, 60% of European FDI has been destined to other European nations (RIS 2002). The EU and NAFTA are both set to expand. NAFTA will be expanded from the US, Canada and Mexico to include Central, South American and Caribbean nations in 2005 to form the Free Trade Area of the Americas (FTAA). The EU is also expected to expand to incorporate the new market economies of Eastern Europe. This is expected to increase the proportion of intra-regional trade and investment even more in Europe and the Americas. This massive trade and investment concentration is going to adversely affect the economic prospects of countries and regions that are not part of FTAA or the EU

since they will struggle to tap into these markets which together form the bulk of world economic output.

It is in response to this situation that Asian leaders have begun to seriously consider the possibility of Asia too forming a regional economic cooperation bloc. At the moment, Asia consists of two major sub-regional economic cooperation groups, that is ASEAN and SAARC (An emerging sub-regional bloc in Asia is the Gulf Cooperation Council (GCC)). Individually, these two blocs have not been successful at matching the performance of NAFTA or the EU. Intra-regional trade in ASEAN is around 22% whilst that of SAARC is a mere 5%. However the latter is to be expected since some sub-regional blocs are less likely to have complementary trading products and are more likely to have competing products, leaving little scope for successful trade in the early years of an RTA.

In the past few years, there have been increasing calls for a wider level of Asian cooperation, including SAARC, ASEAN and Central and East Asian countries. In 1997, ASEAN + 3 was initiated when Japan China and Korea were invited for a dialog with the original ASEAN nations in a step towards future East Asia wide free trade. India too has stepped up relations with ASEAN and became a full dialog partner in 1995, a member of the ASEAN regional forum in 1996, and the first ASEAN-India summit was held in November 2002. At the same time, there have been steps taken to incorporate more Asian nations. The Asian Cooperation Dialog (ACD) was initiated by Thai Prime Minister, Thakshin Shinawatra, in 2001. The first ACD conference was held in June 2002. Discussions were carried out regarding liberalization of trade, investment and financial cooperation along with further cooperation in other fields such as tourism, SMEs, and energy. Similarly, in 2001, China's President Zemin launched the Boao Forum for Asia as a pan-Asian economic forum (RIS 2002).

The potential benefits of an Asian Economic Community (AEC) have been recognized, and the more powerful Asian nations, viz., India, China and ASEAN + 3, are aggressively taking this idea forward.

This paper will discuss the opportunities and challenges that lie ahead in building a successful Asian Economic Community. Section 2 will explore the modern and historical linkages in Asia which could forge a successful AEC. Section 3 will examine some of the benefits of an AEC and Section 4 will outline the challenges that lie ahead. Section 5 has some concluding remarks.

2. Historical Background

For over two millennia, trade in Asia has flourished. The fabled silk route along which nomadic traders sold silk, spices and handicrafts, stretched between East Asia and West Asia from China to Persia. Tea, spices, paper and gunpowder travelled from the East to the Western parts of Asia which in turn supplied horses, gold, silverware and glassware to the East. The Chinese, Indian and Persian empires traded heavily during this period, with South East Asia and the Indian subcontinent being drawn into the ring as maritime trade expanded. Coastal trade grew as ships got bigger and better. It is said that South India had significant trade with Burma and Malaysia since 500 BC. These sea routes between large ancient trading partners touched the smaller Asian nations as well resulting in increased prosperity in these regions.

By the 5th century the straits of Malacca opened up resulting in extensive trade with South East Asia and the rest of Asia, with spices such as pepper leading the way. As trade commenced between East and West, South East Asia was a strategic link between the two. As time passed by the port towns in India, Indonesia, Sri Lanka and Malaysia achieved prominence. Rice being the staple food in the region effectively acted as a currency since other goods could always

be traded for rice which was in demand in most Asian countries. Other significantly traded items were textiles, military goods (elephants and horses) and spices.

This contact led to a great deal of religious exchange and cooperation. Buddhism from India found its way to China, Myanmar, Thailand, Sri Lanka and Nepal. Islam spread from West Asia to reach Malaysia, India, Indonesia, Bangladesh and Pakistan. There is also evidence of a degree of harmony in language, and to this day the languages of neighbouring countries in the region are very similar. Substantial migration has also taken place between trading partners. For example, South East Asia has a large proportion of descendents from China and the Indian subcontinent. Sri Lanka, despite its small population, still has descendents of the Moors from the Middle East, the Malays from South East Asia and Dravidians from South India.

This historical context illuminates the fact that Asia has a common thread that runs through it, and the idea of an Asian Economic Community is not a novel one. If such exchanges occurred in the past, it shows that there is some hope for a recreation in the future. It was the advent of colonialism that created a shift in these ancient trading and economic exchanges. Western powers captured Asian nations, harvested Asian resources and transported them back to the West. This new East - West 'trading' pattern continued after colonialism ended, and continues to this day as Asia depends very heavily on the West for Asia's trade (Table 1). In the coming years, with increasing regionalism in the West, it is probable that these markets will be less accessible to Asia, forcing Asia to return to the bygone era of trade within Asia.

Table: 1 Direction of Merchandise Exports from Asian Countries to the Rest of the World.

| From\To | Asia | | Western Europe | | N & C. America | |
|-------------|------|------|----------------|------|----------------|------|
| | 1990 | 2000 | 1990 | 2000 | 1990 | 2000 |
| Bangladesh | 14 | 7.5 | 34.8 | 46.7 | 32.5 | 41.3 |
| India | 21.9 | 27.6 | 31.3 | 26.7 | 17.2 | 26.5 |
| Pakistan | 27.9 | 23.1 | 41.0 | 29.4 | 15.0 | 28.3 |
| Sri Lanka | 15.7 | 11.7 | 29.2 | 32.4 | 30.2 | 40.7 |
| Cambodia | 91.0 | 37.1 | 5.7 | 15.1 | 0.4 | 47.5 |
| Indonesia | 66.6 | 58.0 | 12.7 | 15.3 | 14.4 | 17.9 |
| Malaysia | 59.0 | 53.8 | 16.7 | 14.9 | 18.6 | 24.9 |
| Myanmar | 79.9 | 47.0 | 9.6 | 19.2 | 3.0 | 30.6 |
| Philippines | 35.9 | 42.1 | 19.5 | 19.7 | 41.5 | 35.9 |
| Vietnam | 43.8 | 46.3 | 7.9 | 30.2 | 0.2 | 8.0 |
| PRC | 61.8 | 46.0 | 10.7 | 15.9 | 9.7 | 30.3 |
| Hong Kong | 44.1 | 53.4 | 21.2 | 15.9 | 28.6 | 25.0 |
| Korea | 37.3 | 43.0 | 17.8 | 16.2 | 37.2 | 29.3 |
| Singapore | 48.4 | 57.2 | 17.4 | 15.4 | 24.4 | 20.4 |

Source: Adapted from ADB Key Indicators of Developing Asia and Pacific Countries: 2001.

Even in the 20th century, there have been occasions where Asian nations have been brought together on a united front. One such occasion was the Bandung conference of April 1955 where African and Asian countries united to strengthen

their independence from Western imperialism whilst keeping a safe distance from the Soviet bloc. The conference highlighted the need for Third World nations to loosen dependence on the industrialized nations and to increase cooperation among themselves in matters of economic, technological and cultural matters. The Bandung conference led to the formation of the Non-Aligned movement in 1961. The writings of Gunnar Myrdal, particularly, "Asian Drama: An Inquiry into the Poverty of Nations" in 1974 which won him the Nobel Prize for Economics, highlights the need for Asia to shed dependence on the West and to increase cooperation within Asia's shores.

Many of the commonalities that united Asia in the past remain today, in particular, the cultural and religious ties. From the point of view of an AEC, the economic foundations appear to be in place, as do the initial signs of political will. The potential benefits are enormous, and similarly the costs of non-cooperation are likely to be significant as well. At the same time, lessons from the past need to be heeded and the path to increased cooperation must be ventured upon with care.

3 Benefits of Asian Economic Cooperation

The main reason for recent discourse on the importance of an AEC is based more on the costs of not forming an AEC rather than the benefits of forming an AEC. The benefits of regional cooperation have been known for a long time since the Europeans began the process of economic integration in the 1950's. The relative success of the EU has prompted the EU to expand and jolted the US into moving towards the FTAA. These two regional blocs will make up the best part of the developed world and form massive single markets. FTAA and EU, assuming their transitions into expansion run smoothly, will reap the benefits of a single market, viz., free movement of resources to where they are most productive, less unemployed resources and specialization to make use of comparative

advantages. All these add up to one thing, increased productivity. A successful EU and FTAA would mean a marginalized Asia that would struggle to compete; it is this worry that has prompted renewed talk of an AEC.

In order to find out whether Asia would be a suitable region to have a successful single market, three basic criteria need to be considered: 1) do the member countries trade significantly?; 2) are there existing barriers to this trade?; 3) are the traded goods competing or complementary? If the countries in question do not trade in the first place, it is unlikely that reducing barriers to trade will make an immediate economic impact in the short run. If the traded goods are competing, there will be little incentive for the countries to trade with one another. For instance, the main exports of SAARC nations are competing, viz., agricultural products and ready-made garments, therefore SAPTA has not yielded significant benefits to the individual countries. One can now examine how Asia as a region fairs on each of these points.

Extent of trade - Asian countries have traded very heavily with the Western industrialized countries (Table 1), this applies particularly to the poorer Asian countries (Bangladesh, Sri Lanka, Pakistan, India, Cambodia, etc.) which offer mainly primary products, ready-made garments and other goods that are not largely produced in industrialized nations. However some of the richer Asian nations (Singapore, Korea, Japan, etc.) export around 50% of their total exports to Asia. Therefore removal of barriers can create trade in a region where trade previously was not significant.

Existing barriers to trade - Asia at present consists of two main blocs, ASEAN and SAARC. Furthermore there are several other bilateral and multilateral FTAs in operation in Asia such as the Bangkok Agreement, BIM-STEAC, BIMPEAGA (Brunei Indonesia Malaysia Philippines east ASEAN Growth area), IMT-GT

(Indonesia Malaysia Thailand growth triangle), Greater Mekong Sub region (GMS), Central Asian Regional Economic Cooperation (CAREC), Pacific Corporation Forum, South Asia Sub-regional Economic Corporation and Asia Pacific Economic Corporation. MFN tariffs on non-agricultural and non-fuel products are low in ASEAN nations and fairly high in SAARC countries (Table 2). The growth of RTAs within Asia and the prevailing tariff structure in Asia indicate that by reducing existing barriers to trade Asia has the potential to gain.

Table: 2 MFN simple averages on non-agricultural and non-fuel products 2001

| Country | Average MFN Tariff Rate |
|-------------|-------------------------|
| Bangladesh | 20% |
| India | 31.3% |
| Sri Lanka | 7.9% |
| Pakistan* | 17.4% |
| Cambodia | 16% |
| Taiwan | 6% |
| Malaysia | 9.3% |
| Philippines | 5.2% |
| Indonesia | 6.8% |
| Japan | 2.7% |
| China | 14.7% |
| Korea | 7.1% |

* 2002

Source : UNCTAD handbook of statistics 2003.

Complementary products - SAARC and ASEAN have relatively low intra-regional trade because their products are competing. However if SAARC and

ASEAN were combined into an AEC, there would be a large range of complementary products. There is a great deal of diversity in the Asian economies, and here lies their greatest potential at success as a RTA. There is diversity in technological capability, in availability of labour, raw materials and services, this results in diverse comparative advantages, in other words, potential gains in trade. For instance, Japan and Korea are world leaders in technological achievements in semi conductors, automobiles and electronics. India has comparative advantages in pharmaceuticals, computer software, and biotechnology, China in consumer electronics and light engineering. There are diverse comparative advantages within industries; East and South East Asia have advanced computer hardware capacity, while India, Indonesia and the Philippines have software capacity. In the ready-made garment industry; East Asia has comparative advantage in textiles and accessories and South Asia in ready-made garment production. In fact one of the major challenges to the continuing success of the ready-made garment industry in South Asia is the lack of access to cheap but good quality textiles and accessories. Such differences within industries allows for efficiency seeking industrial re-structuring.

Attracting FDI from the industrialized nations will become more challenging due to growth of the FTAA and the EU. Therefore creating a single Asian Economic Community would attract more FDI because of the larger market (which combines some of the worlds fastest growing economies, over half the world's population, and commands PPP GNP that is over US \$ 13 trillion -- more than NAFTA and EU). Furthermore, South-South regional investment can be more effective for the receiving country than that from industrialized nations in the form of TNCs. For instance, the technology transferred from South-South FDI is generally more appropriate to the factor endowments of the recipient country and is often adapted to local raw materials. Whereas technology of TNC's can't be reproduced as effectively and doesn't always use domestic raw materials.

(RIS 2004). FDI in general can be very useful for developing countries if the competition it provides manages to drive down prices, resulting in greater consumer welfare for poor people.

In labour markets; Singapore and Japan have a deficiency in skilled manpower (due to a low and ageing population, respectively); whilst a lot of South Asian and South East Asian countries have surplus skilled labour but insufficient domestic demand. Thus the 'demographic dividend' (*a la*, ADB, 1997) can be reaped in Asia itself.

The above are the basic requirements covering trade, investment, and labour for a successful single market, there are several other advantages of increased Asian regionalism, and some of them are highlighted below.

The excessive dependence on the US and EU, US in particular, could leave the region more vulnerable to external shocks. For instance, in the two year period from 2002-2003, the principal Asian economies had a current account surplus of US \$540 billion. These funds were held as official reserves due to perception of vulnerability to a US \$ crash which would hurt Asian exports and create a possible current account deficit. At present, many Asian countries are forced to depend on the IMF for reserve security, but this comes at a cost of limiting 'policy space' (*a la*, UNCTAD, 2004). An advanced step in regionalism could function as a stepping stone so as to expand this fund and further reduce dependence on the IMF. An Asian Currency Swap was a step in this direction. The Swap was established between ASEAN + 3 in 2003 under Chiang Mai Initiative. The process links international reserves of the countries and allows countries to draw 10% of the reserves. This is a step towards increasing Exchange Rate Security which has been a serious issue in Asia since the 1997 currency crash. Since the current Swap mechanism has insufficient reserves to provide

sufficient stability, further integration of other Asian economies could help this cause.

Regional Keynesianism - Many of the more advanced Asian countries have excess savings and capacity in certain sectors. At the same time, other Asian countries have significant unmet demands. Regional cooperation could extend to the lending of funds between these capacity surplus and demand deficient economies. Japan, for instance, has been in a recession from which it is slowly recovering. However, the rest of Asia has suffered due the lack of demand from Japan. Such situations could be avoided if, for instance, the excess capacity in Japan was channelled to other countries in Asia. The loss of output for the region due to Japan's slump has been estimated at 10.15% of regional GDP (RIS 2004).

Furthermore joint funding will be required if plans to improve regional infrastructure do materialize. This could include transport infrastructure, energy infrastructure and telecom infrastructure which would combine to reduce costs of transaction within the region.

Health - Cross border transmission of Malaria, TB and HIV can be arrested by regional cooperation. Resources can be shared to monitor and respond to outbreaks thereby helping curtail the spread of these diseases within the region. An example of this was the SARS outbreak, where all nations cooperated to be extra careful with those entering or leaving the country. Health clinics with X-ray capabilities were a common sight at most airports at the time.

Education - Regional cooperation can be used to create and support regional higher education networks. Thereby economies of scale can be exploited and students from the whole region can benefit from a collective effort. This would be most prudent in subject areas that are highly specialized and no individual

country would find sufficient demand to make such an institute viable. For example, International Rice Research Institute and Asian Institute of Management in the Philippines, the Asian Institute of Technology in Thailand, and the University of the South Pacific in Fiji (www.adb.org)

Environment – Asian cooperation can help curb the cross border spread of effects of environmental degradation. For instance, wealthier Asian nations could share expertise on cleaner fuels; countries with rural poverty could share small scale renewable energy technology and benefit from other success stories.

The above is a list of some of the benefits from an AEC. However, reaping these benefits will be a challenge. In the next section, an attempt is made to outline the economic and external challenges to a successful AEC, which must be met before a full scale AEC comes into operation.

4 The AEC Challenge

The full benefits of regional cooperation are exploited by liberalization of markets for goods, capital, labour and finance and extending this to other areas such as tourism, energy where potential benefits can be extracted. In theory, liberalization would allow factors of production to seek industries where they would be most productive and where highest returns are available, thereby reducing unemployment, increasing output and increasing consumer welfare. Trade is supposed to increase wealth by shifting resources in a country from less productive industries to more productive ones according to comparative advantage. Furthermore it would provide cheaper imports for the consumers in these countries.

Unproductive industries would as a result of competition shut down, but would that immediately create new productive industries? It is easy to destroy jobs but

not so easy to create new ones. Capital and entrepreneurship is needed to start new industries, these are not readily available in many of the poorer Asian countries. The former due to imperfect credit markets and the latter due to education levels that do not meet the standards of the more developed nations. The result of this is that new industries are more likely to be concentrated in the urban areas of countries where credit markets and education standards more closely resemble those of developed nations. Thus easing of protection needs to be slow and measured. For instance, South East Asia and China both systematically eased protection only after jobs were created. China is now dismantling trade barriers 20 years since it started opening out to the market.

Competition policy is relatively weak in poorer nations, and thus there is likely to be little check on the activities of new FDI. Many of developing South Asian economies are encouraging rural entrepreneurship and rural industry in order to trigger economic growth in poorer parts of the country, these moves would be thwarted if unconditional liberalization takes place. The larger urban industries will be able to compete with international firms to a certain extent, but this is not the case for emerging rural producers. This form of disaggregated analysis is needed before large scale liberalization takes place. The burden of costs of liberalization falls unevenly on the poor, and since a large proportion of Asians are poor, their interest needs to be considered more carefully than it has been in the past.

The major powers in Asia have economies that are far more developed than the other Asian nations, thus like in WTO negotiations, there is a danger of trading rules being more favourable to these powerful nations. It is essential that liberalization occurs on an equal footing unlike WTO negotiations where liberalization has favoured developed nations. The same applies to Asia. Japan, for instance, maintains very high tariffs on agriculture.

Those in favour of liberalization of markets cite the fact that markets are better at distributing resources than governments thus markets need to be as free as possible. However this assumes a perfectly functioning market, and therefore countries where markets function better will gain more than countries where markets are less perfect. In Asia, there are both developed and developing countries and the developing countries have markets that are far from perfect. Market systems require effective property rights and legal systems to enforce these, they require near perfect information and they require competition. None of these hold in developing nations. In Europe, the least developed economies were far more developed than some of the average economies in Asia. Therefore it is not just inequality in development that matters, but it is also the actual levels of development that are essential to be considered before regional integration.

There is a risk of the benefits of an AEC being concentrated between ASEAN, India and China. Trade between ASEAN and China has grown by 30-50% per year in the past few years, Indo-ASEAN trade has grown by 30% per year and Sino-Indian trade has grown 52 fold in the past 10 years (RIS 2004). This immediately points towards a trend of regional trade concentration towards these larger Asian entities whilst smaller South Asian, and Central Asian countries are marginalized. There is therefore a case for an in-built Special and Differential treatment in the movement towards an AEC.

Asia is a region where FTA's and smaller RTA's have proliferated. The result of this is a large number of Rules of Origin, preferential tariffs and negative lists (Spaghetti bowl phenomenon). These can be confusing enough in their own right, but in order to form an Asian Economic Community one must reconcile in some way all these different trading agreements which will be no mean task. ASEAN did not have any bilateral FTA's when it came into operation making it a

smooth transition to an FTA. The AEC will have to either integrate the RTAs and BFTAs or supersede them. The latter will be politically challenging and the former logistically very challenging.

Capital market liberalization consists of stripping away the regulations that keep check of capital flows between economies. Ideally this would reduce the costs of investment intra-regionally. However as was discovered in 1997, the bulk of this capital is "hot money" which includes short term loans and stock market play which is speculative investment rather than investment in infrastructure. There are also asymmetries in financial institutions. S.E Asian and East Asian nations have battle hardened and sophisticated financial institutions that learnt lessons from the 1997 crisis. However the same does not apply to the SAARC nations and other parts of Asia like central Asia and the pacific regions. This must be kept in mind if and when financial system integration takes place. The S.E Asian crisis had its roots in financial liberalization in an environment of weak financial institutions. This step of integration would be one that must be approached cautiously and more time is needed till it can be successfully implemented. What could be done is for the developed Asian nations to provide assistance in the process of financial institution capacity building for their developing neighbours.

Most Asian countries are democracies. One of the drawbacks of a democracy is that short term benefits are valued more than long term ones, particularly when long term benefits are not abundantly clear and slow to filter through. To agree to an AEC would entail liberalizing areas which will challenge domestic industries and jobs. Short term unemployment maybe a worthwhile short run cost if the benefit is long run competitiveness, however a countries electorate is unlikely to see things in a similar light, particularly when those who are losing their jobs live on the brink of poverty and have little or no cushion of social security. This power of the electorate was seen in India and Sri Lanka where

governments with neo-liberal economic policies were thrown out of office in recent elections. Therefore it is extremely difficult for governments to pursue the extent of liberalization demanded by an AEC in developing countries in particular. Therefore the formation of an AEC would require a significant political effort and probably a long period of time.

The success of a single market depends to a great extent on the mobility of labour. The United States is an effective single market comprising of 50 states because labour and capital move freely between states. In Asia there are more natural barriers to this movement. Language is an important barrier, it is unlikely that a Korean IT manager will be able to relocate to Pakistan, find employment and manage to lead a normal life. The culture, language and religion in Pakistan are very different to that in Korea. This applies to several other countries. Another factor affecting labour mobility is terrorism. In the post-September 11th era there is a great deal of global mistrust, and Asia has been the victim of terrorism on many an occasion. As a result many countries will be reluctant to open their doors to countries with suspected links to terrorism such as Afghanistan and Pakistan. This is another impediment to free movement of labour.

Infrastructure is another problem, transport and utility costs are very high in certain Asian nations, particularly, the ones located in mountainous terrain. Even in India and Sri Lanka costs of power generation are very high, and in other countries road and rail networks are very poor causing large transport costs. These are natural disincentives for investment into these economies.

There are relatively few current international political disputes in Asia, other than of course the Pakistan-India tensions. Indo-Pakistan relations are one of the main reasons for the failings of SAARC as a regional movement, though the

impact on a future AEC is unlikely to be as significant, there will still be some negative impacts. Internal political instability is however a serious problem. Terrorism has caused civil unrest in many Asian countries; Pakistan, Sri Lanka, Afghanistan and Nepal are a few examples. This would be another disincentive for investment into these countries and an AEC may well create more attractive opportunities for current investors to shift to where there is more stability.

5. Concluding Remarks

The challenges outlined in Section 4 of this paper shows that the road ahead for an AEC is not going to be smooth and it is going to take substantial time and preparatory work to move forward. However there is no need to be discouraged because when the Single European Market and the Euro single currency were being brought about there were similar challenges ahead. If the FTAA comes into being and the expansion of the EU is successful, Asia may well be compelled to form an economic union of her own simply to remain competitive in the global sphere. This paper has argued the importance of forming an AEC, and outlined the benefits that come along with economic union whilst sounding a cautionary note with regard to the possible marginalization of less developed Asian nations. The best way to go about the process would be a phased transition to economic cooperation, with the stronger economies opening up sooner than the emerging economies. It is essential that all voices are heard in the process and compromise is made to ensure fairness and equality, something that has often been missing in WTO negotiations. It is also important that lessons from the past are learnt and knowledge is shared so as to build the capacity of the emerging economies to stand strong in the face of liberalization. The process of liberalization is an inevitable one, it is important to go about this process in a measured and equitable manner.

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