Shaping the Future
of the Asia–Latin America and the Caribbean Relationship

Overview – Executive Summary

IDB/IIC Annual Meeting of the Board of Governors

Montevideo, Uruguay ▪ March 16–19, 2012

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Acknowledgments

Shaping the Future of the Asia–Latin America and the Caribbean Relationship was commissioned by the ADB President, Haruhiko Kuroda, and IDB President, Luis Alberto Moreno, to analyze the increasing economic linkages between Asia and Latin America and the Caribbean and the opportunities for more south–south cooperation between the two regions, as well as the implications for strengthening the institutional collaboration between the two regional development banks.

The report is a major collaborative research effort between ADB, ADB Institute, and IDB under the general supervision of Masahiro Kawai, Dean of ADB Institute (ADBI), and Antoni Estevadeordal, Manager of IDB's Trade and Integration Sector (INT). IDB was responsible for the preparation of Chapters 1 and 4 under the coordination of Mauricio Mesquita Moreira, Research Coordinator of IDB's Trade and Integration Sector. ADB/ADBI was responsible for the preparation of Chapters 2 and 3 under the coordination of Gloria Pasadilla, ADB Institute Research Fellow.

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Overview

American computer pioneer Alan Kay said, "The best way to predict the future is to invent it." Kay's aphorism is relevant to many fields, including international trade and the future of the relationship between Asia and Latin America and the Caribbean (LAC).[1] Although the relationship itself does not need to be invented, governments face the challenge of finding ways to ensure that it generate strong growth benefits not for just the coming years, but for decades into the future, and for all participants.

Economic relations between Asia and LAC have come a long way. Trade with Asia was the main reason why the conquistadores sailed west in the late 15th century, only to discover America. Despite this early connection, a commercial relationship only started to gain importance after World War II with the emergence of Japan as a major investor in LAC, buyer of the region's natural resources, and a supplier of industrial goods. The relationship received another boost with the emergence of the second wave of resource-scarce "tigers"—Republic of Korea, Taipei,China, Hong Kong, China, and Singapore—in the 1970s and 1980s, which boosted trade between the two regions to new heights. Yet, the major turning point would have to wait until the turn of the 21st century. The rise of Asia's most populous economies—the People's Republic of China (PRC) and India—with their manufacturing prowess and insatiable hunger for natural resources, coupled with LAC's reemergence, has made Asia LAC's second largest trading partner in a matter of a decade, while significantly increasing LAC's strategic and economic importance to Asia.

It can be argued that these seismic changes were mainly the product of market forces driven by the immense resource complementarity between the two economies, with little input from governments. However, if the sizeable gains achieved to date are to be expanded, widely distributed, and consolidated, governments must play a more decisive role. Their participation is particularly critical in strengthening and balancing the three key pillars of any successful integration initiative: trade, investment, and cooperation.

This report, a major collaborative effort between the ADB, the ADB Institute, and the IDB, seeks to support this policy agenda. In its four chapters, the report identifies the main challenges and opportunities in each of these pillars while drawing attention to the benefits of balancing their development. The first two chapters review historical antecedents, emerging trade architecture, and trade future scenarios between countries of the two regions. The following two chapters examine opportunities in investments and cooperation.

[1] Throughout this report, unless stated otherwise, Asia refers to Asia–Pacific economies.

Strengthening and balancing the pillars

The three key pillars of integration are closely intertwined. Driven by comparative advantages, the trade pillar usually takes the lead, in the process generating the necessary scale and information for the second pillar, foreign direct investments. A critical mass of trade and investments, in turn, increases incentives for governments to cooperate in a wide range of political, social, and technical issues, which constitute the third pillar. This is not necessarily a linear process, though, and each pillar reinforces the others. More investments and cooperation, for example, create opportunities for trade, and vice-versa. Interactions among these pillars help to create a more stable environment, when one compensates for shortcomings in another. In this way, these interactions produce benefits that go beyond economics and extend to include the political economy. The history of Asia-LAC economic relations in this last half a century roughly follows this pattern, with trade moving first and investment and cooperation catching up later. However, the trade surge taking place in the last decade has created what seems to be an unprecedented imbalance among the three pillars, bringing new challenges.

Chapter I: Dealing with a trade surge

Chapter 1 seeks to put the recent surge in trade into perspective by looking at past trends and projecting into the future. It shows that since the low levels in 2000, trade between Asia and LAC has grown at an annual average rate of 20.5%, reaching an estimated US$442 billion in 2011.[2] Along the way, Asia's share of LAC trade rose to an unprecedented 21%, right behind the 34% of the US, the region's main trading partner. Meanwhile, LAC's share of Asia's trade more than doubled to 4.4%. However, most of this increased activity has been concentrated in only a few countries. On Asia's side, the PRC, Japan, Republic of Korea, and India account for nearly 90% of Asia's total trade with LAC, of which half is carried out by the PRC. As for LAC, Brazil, Mexico, Chile, and Argentina account for close to 80% of the region's total of trade wih Asia.

The surge has clearly been dominated by a commod- ity-for-manufacturing pattern, deepening what has been a hallmark of the Asia-LAC relationship since its early days despite profound structural changes tak- ing place in the two regions. This pattern of trade has translated into a high concentration of LAC's exports in a small number of basic commodities: iron ore, copper, soy, oil, sugar, paper pulp, and poultry; these goods correspond to 70% of all exports. For its part, Asia exports a wide range of manufactured goods, including ships, cars, electronics, equipment and parts and components. In addition to the geographical and product concentration, and to a great extent as a con- sequence of them, the surge has also been marked by some trade imbalances, particularly in relationships involving Mexico and Central America, which do not export commodities. Leaving these imbalances unchecked may lead to undesirable political economy consequences.

Whereas most of these characteristics and challenges merely reflect the way comparative advantages are distributed within and across the two regions, as well as differences in country size, geography, industrial organization of firms and historical circumstances, governments still have ample opportunities for taking action. In this context, Asia's experience of proactive policies to promote competitiveness of its manufacturing sector through trade and investment liberalization, investments in human capital and modern infrastructure, prudent macroeconomic management, among others, shows that appropriate public policies can play a critical role in fostering structural change.

It is particularly important to dispute the notion that the present situation is an inexorable byproduct of the commodities-for-manufacturing trade pattern.

[2] IDB estimate based on LAC reported data.

The gravity of Asia's current and projected resource constraints, as well as its strong and enduring comparative advantages in manufacturing, strongly suggest that this type of exchange will continue to dominate and drive the relationship for the foreseeable future. But this will most likely be in a scenario where commodities, and the industries on which they are based, will be carrying a rapidly increasing technological content, based on advances in areas such as biotechnology, energy and mining. All this against a background where these commodities will continue to enjoy rising demand and relative prices resulting from growing worldwide scarcity. This is a very distinct scenario than the one that prevailed in the second half of the 20th century, which fueled LAC's historical concerns and resulted in often misguided notions about the growth potential of resource-intensive activities.

However, to enjoy the benefits of this scenario, at least two sets of actions must be taken by both regions. First, LAC must make significant investments in upgrading the quality of its supply side, including human capital, trade-related infrastructure, and industrial technology. This is a challenge that both developed and emerging countries in Asia have generally met more effectively, and LAC could learn from their experience. Second, governments of countries on both sides of the relationship must address the high trade costs that still beset interregional trade and undercut opportunities for diversification and technological upgrade.

High costs mainly result from two main factors. First, traditional trade barriers, such as tariff and non-tariff barriers, remain unduly high. A second major challenge is high transport costs resulting from poor infrastructure and limited and inefficient transport services, which is particularly important for trade between distant partners and even more so for distant partners that trade low-value-to-weight natural resources. The resulting trade costs translate into higher food and raw material prices for Asian consumers and firms and lower returns for LAC's agricultural and mining producers.

Chapter 2: Developing an architecture for lower trade costs

There are two pieces of good news about this otherwise worrisome diagnostic of trade costs. First, there is "policy space" to expand and diversify trade, making it possible to address some of the challenges that have accompanied the trade surge. And second, governments and the private sector are using this policy space for the benefit of both regions. Such actions are discussed in detail in Chapter 2, which shows that between 2004 and 2011, an average of two free trade agreements (FTAs) between the countries of Asia and LAC took effect every year, resulting in a total of 18 FTAs as of January 2012. This figure is expected to rise even further as four new agreements have already been signed and are waiting implementation, an additional eight are under negotiation, and 11 more have been proposed. If they all go into effect, a total of 30 FTAs between the two regions will be in force in 2020. Countries with the highest level of participation in FTAs are Chile (6 FTAs), Peru (4) and Panama (2); and Taipei,China (4), Singapore (3), the PRC (3), India (2), Japan (2), and Republic of Korea (2).

The FTAs represented by these impressive figures vary significantly in their provisions regarding speed and coverage of tariff liberalization, number of services sectors covered, and coverage and depth of "new issues," such as intellectual property rights and the so-called Singapore issues (government procurement, trade facilitation, investment and competition). An analysis using these provisions as a measure of the agreements' depth shows that most of Asia-LAC FTAs fall in the middle of the scale, with gradual or rapid tariff liberalization, some or high coverage of services, and a low coverage of new issues. The few "deep," or "gold standard" agreements are the Republic of Korea-Peru FTA (2011), the Trans-Pacific Strategic Economic

Partnership Agreement (2006), and the Australia–Chile FTA (2009).

These last three FTAs liberalize trade in almost all goods and within a reasonable and defined time frame of 10 years or less. The liberalization of trade in services is comprehensive in the case of the Republic of Korea–Peru FTA (2011), while Trans-Pacific Strategic Economic Partnership Agreement (2006) and the Australia–Chile FTA (2009) have only some coverage of services. All three FTAs provide for the automatic inclusion of newly liberalized service sectors. The three FTAs also include meaningful provisions on new issues to promote greater economic integration among all parties, thereby securing the highest possible economic welfare gains from increased trade.

Looking ahead at how to ensure that this fledgling architecture will reduce trade costs, a number of priorities are clear:

- Increase the depth and scope of existing FTAs. The inclusion of WTO-plus provisions is particularly desirable, since competition policy and investment provisions are integral ingredients in strengthening the investment pillar and the development of production networks. Inclusion of provisions on trade facilitation, harmonization of customs procedures, standards, and logistics would help to lower transactions costs. Moreover, properly addressing government procurement deepens market access, and cooperation provisions would strengthen the third integration pillow, which is discussed in more detail below.
- Expand the geographical coverage of these agreements and eventually aim at a broad interregional FTA. Despite their growing numbers, the FTAs either do not cover or are very shallow when it comes to some of the key Asia-LAC trade relationships, particularly those involving the largest economies in both regions. An interregional FTA would be an important means to address this issue, consolidate the plethora of bilateral and plurilateral agreements (and, therefore, address the risk of "noodle bowl" transaction costs arising from the proliferation of rules of origins), and better align their global and regional rules. A recent proposal for an interregional FTA through a Free Trade Area of the Asia–Pacific (FTAAP) has been under serious discussion in APEC. The formation of FTAAP, however, is expected to take many years given the complexity of the negotiations among its 21 potential member economies. Current negotiations for an enlarged TPP, involving fewer countries, are likely to be a useful stepping stone towards a broader and more ambitious integration scheme.
- Ensure firm-level use of FTA preferences. A growing body of evidence shows that LAC began using FTAs as a trade policy instrument relatively early, but it was only recently that firms have begun to utilize the agreements. Now that Asia is a new player in the FTA game, firm-level use is set to rise from present levels. The use of FTAs by firms can be encouraged by raising awareness of FTA provisions, including margins of preference at the product level and administrative procedures for rules of origin. Where possible, best practices should be adopted in these areas. Business associations and governments should increase transparency of information on how to use FTAs, particularly for SMEs.

For all their value and worthy ambitions, FTAs should not be seen as the only instrument available to governments for bringing down trade costs. When deep and broad FTAs face an unfavorable political environment, which delay negotiations for years, if not decades, governments are well advised to explore faster and more focused, sector specific negotiations, particularly in areas where FTAs are not essential and/or their contributions cannot go beyond a certain threshold.

For instance, FTAs that include transport services among their provisions can make a substantial contribution to increase competition, and therefore to bringing down costs. However, lower transport costs can also be achieved with stand-alone initiatives, such as open sky agreements or coordinated fiscal incentives, to increase the supply of direct shipping services between the two regions. The same reasoning holds for agreements on sanitary and phytosanitary conditions and customs procedures. In other areas, such as transport infrastructure, where congested and inefficient ports or airports raise both the freight and time costs of transportation, there is nothing an FTA can do.

In this effort to lower trade costs, all available instruments should be on the table. In this way, a better political and economic balance can be made between the costs and benefits of these instruments.

Chapter 3: Boosting investment

The challenges and opportunities created by the trade surge can be better met by a more robust flow of interregional investments, which is the subject of Chapter 3. Foreign direct investments (FDI) can be a powerful instrument to diversify and upgrade a commercial relationship by allowing firms to jump trade barriers (including those imposed by distance and culture) and by offering host countries capital and knowledge that can eventually be used to upgrade and diversify their exports. They also offer new jobs and help mitigate social costs arising from the unavoidable job dislocations that result from trade and integration between two economies. But above all, such interregional investments are generally good business opportunities that can result in substantial profits.

As specifically regards the Asia-LAC relationship, investment opportunities generally derive from the same fundamentals that have been fueling trade, that is, both regions' immense complementarity of resources and their large and dynamic domestic markets. Instead of just importing commodities, Asian companies can invest directly in the region and in this way help to expand, secure, and add value to their supply. They can also provide manufacturing expertise and, in the process, jump trade barriers to regional and US markets; save on transport costs; and adapt their products to local consumers by making them more competitive.

As for LAC, the region's companies can go beyond exporting commodities to capitalize on its agriculture advantage by offering their expertise in product development, branding, and channel management. In so doing, they would engage the fastest growing region in the world while adding increased value to their exports and expanding profit margins. They can also use FDI to take advantages of Asia's lower labor costs, which would improve their access to Asia's manufacturing market and increase their understanding of Asian consumers.

Chapter 3 provides a detailed examination of recent interregional FDI flows. While firms have been responding to these incentives, the response has fallen short of the opportunities, particularly on LAC's side. More to the point, the gap between trade and investment has grown significantly wider during the recent trade surge. Whereas in previous trade growth cycles from the 1960s to the 1990s led by Japan and Republic of Korea, trade was followed more closely by FDI. We have yet to see this kind of robust FDI response in the current cycle led by the PRC.

That does not mean that Asia's investments in LAC have stagnated. Precise official figures are hard to come by because a substantial share of Asia's reported investment into LAC is directed to offshore financial centers (OFCs), whose final destination cannot be ascertained. If these OFC investments are set aside, the picture that emerges is still one of fast growth, but Asian investments as a share of total inward investment in LAC seem to lag relative to Asia's prominence in LAC's trade. In the case of the PRC, this country's investments (net of OFC transactions) made up less than 1% of LAC FDI inflows in 2010, although its share of LAC trade stood at 11%. Underinvestment on the part of LAC is clearly greater. Net of OFC, the region's investments in the main Asian markets (the PRC, Japan and Republic of Korea) account for less than half a percentage point of total inflows. Meanwhile, LAC's average share of these countries' trade is currently close to 5.3 per cent. Even Brazil, which is the largest LAC investor in Asia, has a big gap between its trade and investment in that region. For example, Brazil's share of Republic of Korea's trade was close to 1.5% in 2010 (or US$12.5 billion), but its investments in the Korean market stood at 0.4 per cent of total FDI inflows (or US$4.1 million)

Official investment figures come with an inevitable lag, which complicates understanding the unfolding dynamics of Asia-LAC economic relations. The story revealed by other sources, such as news accounts of announced investments, provides more reason to be optimistic about a stronger investment pillar in the near future, at least on the Asian side. One such survey carried out by the Financial Times found that the number of Asia-Pacific greenfield investments projects in LAC grew at an annual average of 8% from 2003 to 2010, with estimated capital expenditures growing by 18%. These expenditures rose from US$12.6 billion in 2003 to a peak of US$19 billion in 2008, before falling to close to US$16 billion after the global financial crisis. These figures are even more impressive when mergers and acquisitions are taken into account. In 2010 alone, they amounted to at least US$20 billion.

In terms of greenfield investment alone, the main Asian investors are Japan (39%), the PRC and India (14% each), and Republic of Korea (11%) together make more than three-fourths of the investments in LAC. This breakdown reinforces the argument that the PRC has yet to assume a position among Asian investors in LAC commensurate with the size of its trade flows. In 2010, for instance, PRC accounted for nearly 50% of Asia's trade with LAC, whereas Japan, which continues to lead in investments, had just 18% of trade.

Despite its rapid growth, Asian investment remains concentrated in LAC's largest markets—Brazil and Mexico—which accounted for 53% of projects over the period. The sectoral composition of these investments is better news, particularly for those concerned with the diversification of Asia-LAC trade. Manufacturing assumes a much more prominent role than that observed in trade flows, with both the number of projects and their capital expenditure rising rapidly since 2003 and reaching nearly US$9 billion in 2011. Japan and Republic of Korea are the top manufacturing investors, while the bulk of PRC's investments are concentrated in the mining sector.

On LAC's side, data on investments announced in the media are also more optimistic, but do not fundamentally change the picture of underinvestment in Asian markets. The total number of projects grew at an annual average of 23% in 2003–2010. Estimated capital investment peaked at more than US$8 billion in 2008, but dropped sharply to an annual average of below US$1 billion after the global financial crisis. These investments are mainly directed at Asia's largest economies—PRC and India have 31% and 15%, respectively, of the number of projects—and are concentrated in the services sector, despite a number of high-profile investments in energy and metals. Manufacturing investments are still far and few between. LAC investments in ASEAN markets are trivial.

Firms in both regions bear the sole responsibility in deciding where to invest based on rates of return and investment opportunities. Nevertheless, several public policy instruments can boost interregional investment. These instruments can be particularly helpful in diffusing and reducing the cost of accessing market information and in creating a favorable business environment with low restrictions and stable and transparent rules. Investment and export promotion agencies can be very instrumental in achieving the first objective, whereas for the second, options range from partner specific to more general measures. In the first category are the FTAs with investment chapters and the bilateral investment treaties (BITs). In the second category, measures include the option of unilaterally liberalizing the investment regime, improving regulations on business approvals, permits and registrations, and strengthening the country's market institutions. Evidence suggests that the regions are using all the options available and are making significant progress.

All Asia Pacific-LAC agreements discussed in Chapter 2, with the exception of three, feature dedicated chapters on foreign investment. Those that do not contain such dedicated chapters instead have investment chapters covering FDI in services; these fall under the category of "commercial presence" in the services chapter. Likewise, the number of BIT between Asian and LAC partners have doubled since the 1990s, reaching close to 40 agreements. Both regions have also made substantial progress in liberalizing their respective foreign direct investment regimes since the 1990s, in addition to trade liberalization. Yet, there is no room to be complacent. Bilateral FTAs between Asian and LAC economies and BITs remain limited in their geographical coverage, and lack some of the most important interregional relationships. Significant policy space exists to further liberalize FDI regimes in both regions, as suggested by the OECD FDI restrictiveness index, which places some Asian and LAC economies among the most restrictive FDI regimes in the world.

Chapter 4: Exploring cooperation opportunities

An important but often overlooked facet of interregional relations is cooperation, the third pillar of the Asia-LAC relationship and the subject of Chapter 4. This is also an area where governments are the main protagonists. Unlike trade and investment, cooperation requires that public agencies pursue public policy objectives in what we can think of as "non-market" cooperation. This is admittedly a broad and diverse category that encompasses a wide array of policy areas, diverse institutional vehicles, and many actors at the national and regional levels. For this reason, analysis of interregional cooperation is not an exact science. Little hard data exists that would allow us to quantify and assess cooperation in an area such as education or innovation. Instead, Chapter 4 maps out the current modes of cooperation between the two regions, identifies trends where possible, and highlights challenges and opportunities.

Non-market cooperation between the two regions appears to be on the rise. Even over the past five years, bilateral development aid has increased notably. There has been a flurry of agreements and memorandums of understanding on topics such as education, scientific research, and energy. New Asia-LAC multilateral forums have appeared on the scene. In addition, we have seen efforts by LAC and Asian countries to take joint action in international bodies such as the UN, WTO, and the G-20. At the same time, for most countries on both sides of the Pacific, Asia-LAC- cooperation is a relatively recent phenomenon and less extensive than their engagement with other regions.

Prospects are excellent for accelerating Asia-LAC-cooperation in the coming years. The PRC, Brazil, India, and Republic of Korea are becoming increasingly important sources of development aid, and the comparable stages of development of many LAC and Asian countries present opportunities for sharing knowledge and experiences that are particularly relevant and transferable among each other. Such complementarity gives these countries a potential comparative advantage in aid provision vis-à-vis traditional donors. Similarly, successful development experiences of LAC and Asian countries also lead to complementarities between the two regions. Asia's world-class education systems, high level of science and technology sophistication, and successful export promotion policies could offer important lessons for LAC countries. LAC's experiences in poverty reduction policies, agriculture, mining, and urbanization could be relevant to Asian countries.

The growing number of Asia-LAC formal trade and investment agreements, as well as other diplomatic relations, whether they take the form of bilateral arrangements or participation in multilateral forums, present opportunities to expand cooperation into non-market areas. Many of the trans-Pacific FTA's signed in recent years include language on cooperation in areas such as education, science and technology, agriculture, and environmental issues, to name only a few. For example, in the Japan-Mexico Economic Partnership Agreement, words have translated into actions, with the signatory countries carrying out over a dozen joint activities since the agreement came into force in 2005.

At the multilateral level, interregional trade negotiations are moving towards deeper cooperation in areas such as procurement and customs procedures that involve domestic policy. At the same time, new interregional forums are being created to enhance cooperation. Both trends point to increased opportunities for non-market cooperation. Finally, as LAC and Asian leaders make more and more trans-Pacific visits, we can only expect a further proliferation of agreements, MoUs, accords, and protocols for non-market cooperation.

On the international stage, countries in LAC and Asia have a unique opportunity to advance concrete initiatives on key global issues such as international financial regulation, climate change, and the governance of multilateral institutions. More coordination and dialogue between countries in the two regions will ensure that LAC and Asian countries can effectively influence the evolving global governance apparatus in areas where common interests exist.

How can LAC and Asian countries make the most of these opportunities for cooperation? A few observations can be drawn based on the Asia-LAC cooperative initiatives undertaken to date. First, given the wide range of actors involved (foreign ministries, international cooperation agencies, national development banks, export-import banks, and ministries in areas such as education, science and technology, and energy), strategic planning and coordination across institutions is key to the success of cooperation initiatives. Secondly, cooperation efforts have been most effective when they enjoy strong legal and institutional underpinnings, such as legal standing, concrete objectives, and sufficient funding. For these purposes, MoUs are notably weak vehicles, whereas trade agreements, which increasingly include non-market cooperation in their scope, may provide a firmer platform.

Finally, it is important to pick and choose areas of cooperation carefully. Initiatives have the biggest impact where there is both supply and demand, that is, where there is relevant expertise or knowledge to share and true priorities to address. In addition, cooperation initiatives should not run up against national or private sector interests. Examples of high-potential areas include infrastructure, climate change, poverty reduction, natural disaster mitigation, and financial regulation. The Asian Development Bank and the Inter-American Development Bank, the regions' major development partners, have a role to play in promoting Asian-LAC economic cooperation. Potential avenues include conducting further research on Asia-Latin American economic ties, organizing joint conferences and policy dialogues, exchanging operational best practices, financing results-oriented cross-regional technical assistance and capacity building activities, and contributing to trade-related interregional infrastructure, (e.g. seaports and trade facilitation).

The challenges to effective cooperation are also considerable, running the gamut from implementation issues mentioned above to more fundamental questions about the nature of interactions between states. International relations theorists have often been skeptical of cooperation, arguing that states act in response to factors that may or may not promote cooperation. This reality can be observed in Asia-LAC relations, such as examples where successful cooperation exist side-by-side with conflicts over trade practices. Trade between the two regions, while greatly beneficial for both sides, has also led to imbalances and worries in LAC countries over lack of diversification and the technological sophistication of its exports. Although this report suggests that some of these concerns are overstated, they are still likely to hang over the political economy of the Asia-LAC relationship in the future. For this reason, it is all the more important for LAC and Asia to choose carefully among cooperation initiatives, focusing on areas where the right incentives exist and where institutional backing and coordination are sufficient. Successful non-market cooperation can be particularly effective in alleviating the growing pains and inevitable imbalances of a relationship whose importance has surged in the last decade and which is likely to keep surging in the decades come.

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