Regional Integration and Industrialization Strategy in LDCs: The Case of Southeast Asia

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Content

1. How production networks have expanded in East Asia - mechanics of production fragmentation
2. Policy measures to participate in production networks
   + Treatment of agglomeration economies in the context of regional integration
3. Summary of policy implications
Mechanics of Concentrated Dispersion:
Sequential “take-off” of less developed economies in East Asia

- **Dispersion force** ↔ local factor price, competition in local market, etc.
- **Agglomeration force** ↔ firm level IRS, local externalities (spillover effects), etc.

**Concentrated dispersion**

Progress in agglomeration ➞ Saturation (wage↑, rent↑)

\[
\begin{align*}
&\text{Sprawl to the neighboring area} \\
&\text{Leap-out to the remote area linked by logistic networks} \\
&\text{(incl. fragmentation)} \\
&\text{Formation of a new agglomeration at a remote area}
\end{align*}
\]

Source: Nishikimi and Kuroiwa (2011)
Dispersion forces and production fragmentation (Example: Thailand-Laos)

Vertical Fragmentation between Pre- and Final-Assemblies

National Border

Core

Periphery

Final-Assemblies

No tax / No tariff for material & parts import

Bonded transportation Through Thailand

Export to the World

Note: PB: Production Block
Source: Suzuki (2009)
Costs and benefits of production fragmentation

• Benefits
  = Lower wages (land rents, etc.)
• Costs
  = Transportation, communication, etc. (i.e. service link costs)
  + Less favorable investment environment in LDCs

If Benefits > Costs, production fragmentation will occur.
  In the above formula, “Costs” can be reduced significantly by policy efforts.
  Production processes to be shifted to LDCs are sufficiently labor intensive, and their scale economies or agglomeration economies are relatively weak.
Industrialization Strategy in LDCs: The Case of Cambodia, Laos, and Myanmar

**1) How to reduce service link costs?**

RTAs (AFTA, ASEAN-China FTA, ASEAN-India FTA), regional transport infrastructure and facilitation (GMS and CBTA) plus WTO and GSP

→ lower trade and transport costs across borders

**2) How to narrow the gap in investment environment?**

Efficient infrastructure, institution, human resources ... are necessary. However, the resources are limited.

→ SEZs are strategically important.
(3) *Where to locate SEZs?*

Frontier regions (border regions and port cities) have gained location advantages after economic integration (as in North America and Europe). But metropolitan areas are still attractive.

(4) *Attracting industry activities - from where?*

Neighboring developing countries, such as China and Thailand, are major investors. Border regions attract FDI from adjacent countries.
(5) *Attracting industry activities* - in which industry?

Production fragmentation may occur, as long as transport costs are relatively low, production processes are divisible, labor intensive, and technically simple and stable (Lall et al. 2004).
• However, *regional integration is not a panacea.*

(6) *The “Straw effects”*

Increasing returns to scale (IRS) faced by a firm, local externalities (knowledge spillovers, access to local market, suppliers, etc.)

→ **stronger agglomeration forces** in larger countries

→ IRS industries in LDCs could be swallowed by larger countries (or may lose an opportunity for future development) through the “straw effects”.

→ **Integration should be delayed** for some IRS industries, or policy measures should be taken to protect infant industries.
(7) *Coordination failures in agglomeration development*

Stiff Competition in luring agglomerations
→ Only a few succeed in fostering industry clusters
→ *Necessity of policy coordination* in the region

- **Policy coordination in ASEAN:**
  1970s  Allocation of IRS industries + PTAs (AIP scheme)
  1980s  BBC scheme→ AICO scheme→AFTA

**Lessons:** *Private sector involvement is crucial in policy coordination.*
• Further policy implications:
  (1) Participating in production networks should be a top priority.
     → **Generic policies are more relevant** to improve investment environment and reduce service link costs
     → **SEZs should be set up in strategically important locations such as frontier regions.**

(2) Industrial clusters should be developed after participating in production networks.
→ **Active industrial policies** might be necessary in later stages of industrial development.
Which industrial clusters should be promoted?

Market potentials of clusters

Source: Fujita 2003
(3) LDCs lack financial resources to build transport and other ancillary infrastructures.

→ Regional development banks and higher income countries in the region should provide funding.

(4) Policy coordination in the region is crucially important.

→ Regional organizations should play a leading role in effectively promoting regional cooperation and integration.
Thank you very much.