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CHUNG-HUA INSTITUTION FOR ECONOMIC RESEARCH

**THE PROSPECTS FOR ECONOMIC  
INTEGRATION AMONG THREE  
CHINESE ECONOMIES**

JIANN-CHYUAN WANG

*OCCASIONAL PAPER SERIES No. 9409*

November 1994



財團  
法人 中華經濟研究院

CHUNG-HUA INSTITUTION FOR ECONOMIC RESEARCH  
75 Chang-Hsing St., Taipei, Taiwan, 106  
Republic of China  
TEL : 886-2-735-6006  
FAX : 886-2-735-6035

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**The Prospects for Economic Integration  
among Three Chinese Economies**

by

**Jiann-Chyuan Wang**

*Research Fellow*

*Chung-Hua Institution for Economic Research*

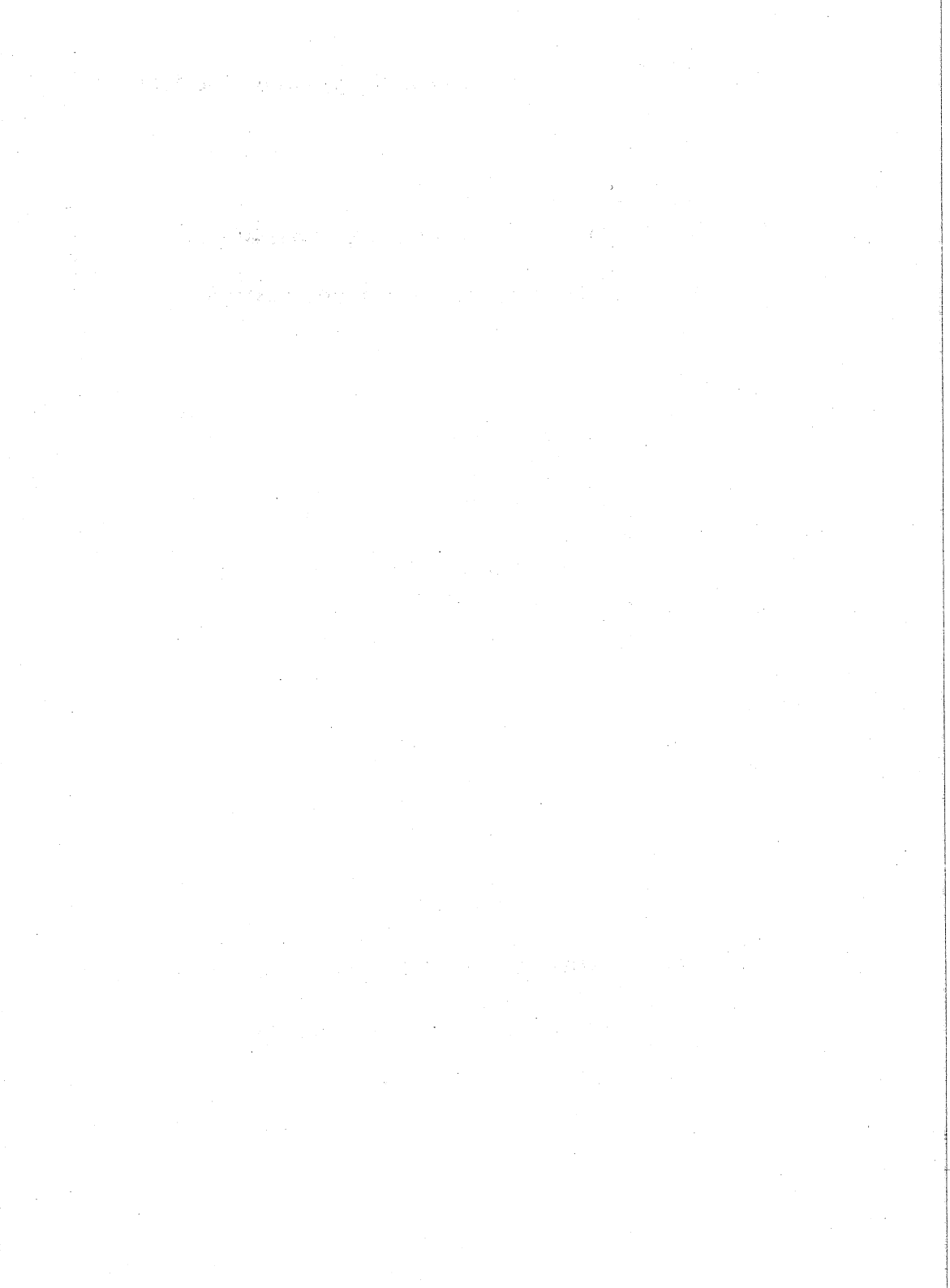
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**Republic of China**





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JIANN-CHYUAN WANG

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## **The Prospects for Economic Inegration among Three Chinese Economies**

### **Abstract**

This paper analyzes the costs, benefits and obstacles of economic cooperation between Taiwan, Hong Kong, and China from the economic perspective, and considers the views of the U.S. and other Asian countries regarding this possibility. We conclude that a formal organization for economic cooperation among the three Chinese economies is rife with difficulties for the time being; however, increased intra-regional trade and investment in these three economies, the potential market of mainland China, and the fact that closer economic cooperation will push forward a more harmonious, stable relationship between the two sides of the Taiwan Strait should not be neglected.

Under such circumstances, reducing trade barriers, eliminating restrictions on factor movement, and jointly developing industries which require economies of scale in order to strengthen the economic cooperation of the region is advisable for Taiwan's current interest.

### **I. Introduction**

Since the end of the cold war, economics, rather than politics, has become



the driving force of the world's resource allocation, and the geopolitical landscape has altered accordingly. Under such circumstances, the idea of forming regional economic blocs, either for the purpose of strengthening economic power or transforming economic structures, has been emerging. The North American Free Trade Area (NAFTA) and the approaching economic unification of the European Community (EC) illustrate the trend toward regionalism.

As such, there has been talk of pursuing economic integration among the three Chinese economies of China, Hong Kong and Taiwan. This idea has been discussed under several different names, as we will see below, although these has been no formal proposal of any kind.

Since the late 1980s, economic reform in China and the diminishing political hostility between Taiwan and the mainland authorities has intensified economic interdependence between the two sides of the Taiwan Strait. The trade between Taiwan and China via Hong Kong has been increasing sharply, from US\$0.3 billion in 1980 to US\$7.7 billion in 1993. In addition to increased bilateral trade, the recent surge of Taiwan's indirect investment toward mainland China, which has amounted to over US\$10 billion in the last ten years, has given rise to much discussion of the emergence of economic cooperation between Taiwan, Hong Kong and China. In the region, these three economies enjoy a large degree of resource complementarity. Taiwan provides an ample supply of investment funds and competitive industrial manufacturing technologies. Hong Kong has competitive strength in its marketing network, finance infrastructure and telecommunication system. South China offers an abundant supply of natural resources and cheap labor.

However, the trend toward regionalism, the increasing volume of trade and investment, and the great resource complementarity among Taiwan, Hong Kong, and China does not imply that the relevant government authorities have the intention of forming an economic bloc. Before economic cooperation progresses further, we should explore the feasibility of such economic integration from every angle, for instance, the level and the extent of such economic cooperation, the economic perspective. In addition, we should consider the views of nonmember countries in order to avoid major difficulties.

The purpose of this paper is to evaluate the feasibility and prospects for economic integration among the three Chinese economies from the economic perspective and to consider the views of the U.S. and other

Asian countries with regard to this possibility, and provide this information to the Taiwanese government.

Section II presents a brief overview of the literature on economic integration in general as well as on economic integration among the Chinese economies, in particular. In Section III, we then explore the feasibility of such a zone or circle from the economic perspective and views of nonmember countries such as the U.S. and other Asian countries regarding the prospect of such an organization. The future prospects of a Chinese regional circle of economic integration are discussed in Section IV. Section V contains concluding remarks and suggestions.

## **II. Literature Review on Economic Integration and a Chinese Regional Trade Zone**

As a result of the North American Free Trade Agreement and the unification of the European Community, the formation of trading blocs and fragmentation within the world trading community is a trend that promotes regionalism. Even though Taiwan, Hong Kong and China are different in their endowments of natural resources, their political systems and their stages of development, the increasing subregional division of labor, intra-regional trade, and investment among them have given rise to their closer economic cooperation. It is natural, then, to consider extending and formalizing this situation into a regional trade organization, a Chinese regional economic circle, which we can abbreviate to CREC for this paper.

Before reviewing the feasibility of a CREC, we first introduce the stages and the theoretical background of economic integration. We then elaborate on the level and the extent of economic integration proposed for the greater Chinese region by scholars. Finally, the benefits and costs of integration will be addressed in order to provide readers a clear understanding of the setup.

### **1. Stages of Integration**

According to Root (1990), regional economic integration can be classified into four stages based on the degree of integration:

- (i) Free trade area: The main feature of a free trade area is that it



abolishes all restrictions on trade among member countries, while each member country retains its own tariff and trade intervention policy measures directed at non-member countries. The North American Free Trade Area of the U.S., Canada and Mexico can be classified into this stage of integration.

- (ii) Customs union: A customs union can be defined as a group of countries that remove all restrictions on mutual trade, and erect a common external tariff.
- (iii) Common market: In addition to the features of the customs union, a common market involves the removal of all restrictions on the movement of productive factors -- labor, capital and enterprises -- between member countries. The European Community is now at this stage of integration.
- (iv) Economic union: The objective of economic union goes beyond the free movement of productive factors. The member countries also agree to harmonize and unify their social, fiscal and monetary policies. The European Community is attempting to establish an economic union.

Table 1 Stages of international economic integration

Stages of integration	Abolition of tariffs among member countries	Common tariff and quota system	Abolition of restriction on factor movement	Harmonization and unification of economic policies and institutions
1. Free trade area	Yes	No	No	No
2. Customs union	Yes	Yes	No	No
3. Common market	Yes	Yes	Yes	No
4. Economic union	Yes	Yes	Yes	Yes

Source: Root (1990)

As for the idea of CREC, literature on the level, extent, institutional framework, and member countries is very diverse. Huang (1980) initiated the idea of Chinese regional economic cooperation in 1970; he predicted that a "Chinese International Community" would emerge at the end of 1980s. However, his prediction did not draw too much response at that time. Recently, Cheng (1988) continued to develop a similar idea. He proposed a "Greater Chinese Common Market" and attracted a lot of

attention. But his so-called "Common Market" is neither a customs union nor an economic union. The former may cause antagonism among non-members, while the latter involves free movement of labor and capital, which is not realistic considering the different stages of economic development and political systems involved. In Cheng's proposal, the member countries of the "Greater Chinese Common Market" would include Taiwan, Hong Kong, Macau, China and Singapore. The reason for Singapore's participation is that it would emerge serve as the bridge and buffer between Taiwan and China, and pave the way to creating an all-Chinese common market. In order for his idea to be realized, he proposed that several things need to be done: first, obstacles among members should be gradually eliminated; second, offer a reasonable guarantee of member countries' investment must be offered; third, technologies and resources must be pooled together to organize several joint ventures to upgrade production technology in the area. In addition, Kao (1988) has proposed an "Asia Common Market," and Chou (1988) has formulated the idea of a "Southeastern China Free Trade Area." These two ideas are basically similar to the other two proposals outlined above, and both support organized economic cooperation.<sup>1</sup> Details of the various proposals as to the level and member countries to be involved in economic cooperation between Taiwan, Hong Kong, and China are summarized in Table 2.

## 2. Theory of Economic Integration

Theoretically speaking, countries are eager to undergo economic integration only when they feel integration benefits outweigh costs. Therefore, before examining the feasibility of a CREC proposal, we should elaborate on the benefits and costs of regional economic integration. According to the traditional wisdom of Viner (1950), the benefits of integration, from an economic perspective, occur when the abolition of internal tariff and nontariff barriers stimulates new trade among member countries and allocates resources more efficiently. These benefits are often

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<sup>1</sup>Organized economic cooperation means formalized cooperation, and is different from looser economic cooperation. In such a cooperative system, member countries jointly formulate cooperative regulations and laws related to trade and investments through a negotiation process, in order to push forward economic integration. The North American Free Trade Area and the European Community are two examples of organized economic cooperation.

termed the trade creation effect. On the other hand, member countries buy more from each other, replacing low-cost producers outside the member vounytird.

This is known as the trade diversion effect. As long as the trade creation effect outweighs the trade diversion effect, the result is higher allocative efficiency, and thus higher welfare for the member countries. However, if the opposite occurs, that is, if the trade diversion effect outweighs the trade creation effect, overall welfare will thus be reduced.

Table 2 The Idea of a Chinese Regional Economic Circle (CREC)

Name	Initiator (date)	Stage of proposed integration	Proposed member countries (areas)
1. Chinese International Community	Huang, Chin-Lien (1980)	common market	Taiwan, Hong Kong, Macau, South China
2. Great Chinese Common Market	Cheng, Chu- Wei (1988)	common market	Taiwan, Hong Kong, Macau, China, Singapore
3. Asian Chinese Common Market	Kao, Hsi- Chun (1988)	common market	Taiwan, Hong Kong, China, Singapore
4. Southeastern China Free Trade Area	Chou, Pa- Jiunn (1989)	free trade area	Taiwan, Hong Kong, Macau, Singapore

Sources: 1. Huang (1980)  
2. Cheng (1988)  
3. Kao (1988)  
4. Chou (1989)

Both trade creation and trade diversion as mentioned above are static effects. Regional economic integration can also have dynamic effects in that it can help local industries achieve economies of scale that could not be achieved in a narrow national market. In addition, to pursue broader market opportunities resulting from integration, and enhance competitive strength to face new challenges, firms are willing to make new



investments, which will create new jobs and promote economic development. Another important motive for integration is the possibility of increased political clout. Regional integration will create a single voice representing all member countries, and can serve to counter other trading blocs, and reap greater political and economic benefits in the international environment.

### **III. The Feasibility of a Chinese Regional Economic Circle**

In this section, we will focus on the economic prospects for such regional economic cooperation in the Chinese culture area. We consider, for instance, the trade creation and diversion effects, economies of scale and the international division of labor. In addition, we will examine the reactions from the other U.S. and the Asian countries regarding this idea, to explore the feasibility of a CREC.

#### **1. Economic Prospects**

##### ***(i) Trade Creation and Diversion Effects***

Although the productive activities between Taiwan and China are basically complementary, or vertically in line with each other, the trade creation effect is expected to be large after forming CREC. However, Taiwan and Hong Kong trade relatively little with each other (apart from entrepot trade between Taiwan and China via Hong Kong) and both rely on imports mostly from outside the region. Thus, they have to import comparatively disadvantaged goods from each other or China and suffer trade diversion after integration. Moreover, indirect trade between Taiwan and China has risen sharply in recent years; nevertheless, the volume of this entrepot trade represents only a relatively small share of world trade. From Table 3, one can see that the GDP of Taiwan, Hong Kong and China together is far less than that of North America, the European Community and the Asian countries, respectively. Before the purchasing power of China increases significantly, these three economies will have to continue to rely heavily on trade with countries outside the region. Even though negative factors such as deficient transportation infrastructure, overvalued

currency and lack of purchasing power that constrain intra-regional trade will be improved in the future, and trilateral trade within this region may grow considerably, political disputes and differences both in stages of development and the political-economic systems cannot be easily solved in a short period of time.

On the other hand, if the degree of trade dependence increases because of the surge of intra-regional trade, this might hurt the Taiwanese government's bargaining power on matters relating to relations between the two sides of the Taiwan Strait. Moreover, until direct flights between Taiwan and China begin, the transportation costs of entrepot trade via Hong Kong will remain high. Based on these factors, it is too optimistic to think that huge gains will be won by forming CREC for the time being.

Table 3 GDP and commodities of world trade

Unit: billion U.S. dollars

Area	GDP	Exports	Imports
North America	4,952	860	926
EC	4,035	1,349	1,468
Asia Pacific*	2,894	428	419
Taiwan, Hong Kong, China	397	186	168

Note: \*includes Australia and New Zealand.

Source: *World Economic Outlook* (The WEFA Group, 1992)

### (ii) *Economies of Scale*

Within the three Chinese economies, Hong Kong, with its narrow domestic market and competitive relationship with Taiwan, does not have the capacity to absorb many exports from Taiwan. And China even with its open door policies, still has quite a few restrictions on imports; therefore, Taiwanese firms investing in China are basically oriented toward exports rather than toward the Chinese market. Currently, China's authorities are lifting some restrictions on imports. However, because China is seeking to join GATT, China will be unable to offer Taiwanese firms special privileges or easier access to its domestic market. This

implies that Taiwanese firms will unavoidably face fierce competition from foreign firms in the China market, and uncertainty arises as to whether Taiwan can substantially enlarge its market share in China. Under such circumstances, it is uncertain whether China's big potential market can help Taiwanese firms realize scale advantages.

### *(iii) International Division of Labor*

According to Heckscher-Ohlin's factor endowment theory,<sup>2</sup> a country has a comparative advantage in the production of goods that use relatively large amounts of its abundant factors of production, and a comparative disadvantage in the production of goods that use relatively large amounts of its scarce factors of production. In this sense, it is appropriate for China, with its abundant cheap labor, to develop labor-intensive industries. By contrast, Taiwan and Hong Kong, each with their surplus capital and rising labor costs, should specialize in capital- and technology-intensive industries to enjoy a comparative advantage. The great resource complementarity and different development stages of these three economies creates a favorable environment for the division of labor, leading to efficient resource allocation.

However, according to the so-called "flying geese pattern" of development conceived by the Japanese economist, Kaname Akamatsu, the advanced country develops first, becoming the lead "goose" or country, passing on its out-of-date industries to less developed countries in the region. The developing countries then play catch-up in the consumer goods and capital goods markets. This pattern of development is basically a vertical rather than horizontal division of labor. Located downstream in this vertical system, China is forced to absorb labor-intensive industries which no longer have a comparative advantage in Taiwan and Hong Kong. As time goes on, this will intensify China's dependence on materials, technologies, and machines from Taiwan and Hong Kong, resulting in a large trade deficit with the two areas. This contradicts the development strategy laid out by China's authorities, which focuses on developing capital- and technology-intensive industries.<sup>3</sup>

<sup>2</sup> See Root (1991) Chap. 3 pp. 67-93.

<sup>3</sup> Aiming to seize China's potential domestic market, some technology-intensive industries from Taiwan have already made investments in China, and shortened the gap in the vertical division of labor between Taiwan and China. Although this trend matches



Hence, the complementary pattern of economic cooperation to promote productivity sounds good in theory, but will face difficulties in practice. And when political disputes are taken into account, the problem becomes even more complicated. The conflict between an individual country's interests and the workings of the international division of labor is one of the main reasons for trade friction among Taiwan, South Korea, and Japan. In the future, this may also cause conflicts between Taiwan and China, and is a factor working against the development of CREC.

#### *(iv) Macroeconomic Factors*

Although China has tacitly accepted the validity of some Western concepts such as comparative advantage and the international division of labor, it still is committed to a planned economy, which is totally different from Taiwan and Hong Kong's capitalist economies. Therefore, some sticky problems exist for the establishment of a fundamentally free trade area. Furthermore, due to the continuing political hostility between Taiwan's and China's authorities, it is not pragmatic for the two sides of the Taiwan Strait to undertake deeper economic cooperation, since macro-interdependence would force these two governments to alter some of their policy measures, not to mention the problems that would arise with proposals for a unified currency and free movement of productive factors.

## **2. View from the U.S.**

The U.S. thus far has been the largest importer of Asian products. Its technologies and management system also play a crucial role in the industrial development of Asian countries; hence the attitude of the U.S. toward CREC and the effect that CREC would have on trade with the US will have decisive impacts on the formation of CREC.

In view of the latest developments, it is clear that U.S. trade policy is undergoing a change. The U.S. used to be a proponent of the free trade principle; however, due to its large long-term trade deficit, after the mid-1980s the U.S. began to request that its trading partners provide a fair competition environment. In an attempt to obtain such an environment on a case-by-case basis, the U.S. has shifted its trade policy from the free

(.....Continued)

China's industrial development strategy, it may result in Taiwan's deindustrialization and thus hurt Taiwan's international competitiveness.

trade to a mutual benefit principle. Especially after the negotiation of the North American Free Trade Agreement, bilateral agreements may become the U.S. trade negotiation pattern.

Because of this U.S. bilateral trade negotiation pattern, diversifying exports, markets, and investment to spread risk seems more urgent for the three Chinese economies than creating a CREC. Moreover, China has a weak record on environmental protection and intellectual property rights. As a consequence, if Taiwan joins CREC, Taiwan may also suffer the effects of any U.S. retaliation against China because of China's problems in these areas.

Furthermore, both Taiwan and China heavily rely on the U.S. market, thus the bargaining power of Taiwan with the U.S. is limited and Taiwan has had to surrender several times under the pressure of Section 301. It is expected the U.S. will continue to apply Section 301 to deal with countries like Taiwan which enjoy handsome surpluses with the U.S. Because of this, rejoining GATT<sup>4</sup> to obtain a channel to resolve trade disputes with the U.S. more equitably, or pushing through a "Sino-American Free Trade Agreement" should be of higher priority for Taiwan than creating a CREC.

### **3. View from the other Asian Countries**

#### ***(i) Competing for Capital and Technology Resources with China***

As the unification of the European Community continues, European multinational firms will withdraw some of their previous investment in Southeast Asian countries, and reinvest it in the labor-abundant South European EC member states (such as Spain and Portugal). Under such circumstances, the Southeast Asian countries will badly need Taiwan's and Hong Kong's capital and technology to promote economic development and solve their external debt problems.

If CREC were enacted, under the preferential tariff treatments, more and more investment from the two other members would flow into China, crowding out allocations of capital and technology to the Southeast Asian countries, which will not make them happy. Moreover, the possible decline of U.S. imports due to the trade deficit and the emergence of a single market in Europe may intensify protectionist sentiment in Asia. The

<sup>4</sup>Taiwan withdrew from GATT on behalf of China in 1950.

continued prosperity of the Southeast Asian countries can provide a broad market for Taiwanese products to take up the slack in the long run. Hence, intensifying economic ties and avoiding unnecessary friction with them is in Taiwan's best interest at the moment.

*(ii) The Prospect of Asian Economic Cooperation*

Asian countries are diverse in their endowments of natural resources, stages of development, and in their cultural and historical heritages. Therefore, creating Asian economic cooperation would not be an easy task when compared to the formation of the North American Free Trade Area or the EC. Nevertheless, given increasing interdependence in the areas of trade, investment and labor, the economic strength of Japan and the NICs (Taiwan, Hong Kong, South Korea and Singapore), the potential markets of Southeast Asia and China, and the absence of insurmountable infrastructural barriers to the development of regional cooperation in the Pacific Rim region, the formation of Asia-Pacific Economic Cooperation (APEC) is not without merit.

Although intra-East Asia trade is on the rise in recent years, almost 60% of Asia's exports went to the rest of the world outside the region. Especially, trade with North America continues to be a major source for its dynamism.

Therefore, the U.S.-inclusive APEC provides not only a huge export market but also advanced technologies, and aims at creating an "outward-looking," "nondiscriminatory" economic cooperation system. As a consequence, a larger group like APEC, relative to a 3-member CREC, can better realize the benefits of economies of scale and the division of labor as well as ensuring a stable, free multilateral trading system, preferably globally and if not that, at least in the Asia-Pacific region. Moreover, Taiwan can use an open trading bloc like APEC as a channel to exert influence in the Asia-Pacific region and need not worry about China's dominance on political and economic issues.

In sum, from the economic perspective, and from the viewpoint of the reactions of the U.S. and other Asian countries, the formation of a CREC is premature and rife with difficulties at present.

## IV. Future Prospects

Based on previous arguments, organizing a CREC at present is problematic and does not fulfill Taiwan's current interests. However, if the two sides of the Taiwan Strait can put political disputes aside and work on preliminary economic cooperation based on the principle of comparative advantage, the following benefits can still be realized:

- (i) Economic cooperation even at an informal, indirect level, can push China to further political openness. Because of this, Taiwan should take a neutral attitude in governing the recent surge of Taiwan's indirect trade and investment toward mainland China. Once China catches up in the development process, not only can it provide Taiwan a broad export market, but also it will be forced China to undergo political reform. The relationship between Taiwan and China can thus be further stabilized.
- (ii) Resource complementarity can enhance production efficiency. Under the system of a vertical division of labor, Taiwanese firms can shift their production sites to China. This pattern of division of labor can create employment opportunities and benefit China's management system. Likewise, Taiwan can promote efficiency and enhance its international competitiveness through the advantage of the division of labor. However, as mentioned in Section III, any substantial trade imbalance between Taiwan and China resulting from the system of vertical division of labor will have to be addressed sooner or later.
- (iii) CREC can promote the region's bargaining power in the international community. The free trade pact between the U.S., Canada, and Mexico and the single market in Europe may lead to protectionist measures and to discrimination against other countries outside of those regions. It is noteworthy that Taiwan, Hong Kong and China could collectively use CREC for greater influence in the Asia-Pacific region to preserve a free and open trading and investment system there. Thus, economic integration of these three economies and the formation of a single voice can help to increase the region's bargaining power and serve to encourage free trade.

Although the formation of an economic bloc for Taiwan, Hong Kong and China is not necessary, these governments should not purposely draft policies which restrain the trade and investment activities of the region. They should let nature take its course since open, nondiscriminatory economic cooperation is advisable for Taiwan's current interests. Therefore, specific advice regarding the future possibility of a CREC can be summarized as follows.

First, reduce trade barriers gradually in the region. Since Hong Kong, Taiwan, and China are all developing countries, rushed cooperation and a drastic liberalization movement may jeopardize China's infant industries, Taiwan's agricultural industry, and Hong Kong's manufacturing industries. Except in several complementary industries, reducing nontariff barriers to enhance productivity is workable.

Second, remove restrictions on movement of productive factors. China is rich in cheap labor, while both Hong Kong and Taiwan have a labor shortage problem. As a consequence, Taiwan and Hong Kong should make efforts to relieve restrictions on importing China's labor, and hire manual laborers as well as technology experts to alleviate the labor shortage problem. Additionally, Taiwan and Hong Kong have an ample supply of capital, which is badly needed by China during the development process. Based on the consideration of mutual benefit, China's authorities can work on abolishing restrictions on capital movement and foreign investment.

Third, jointly develop high-tech products to spread risk.<sup>5</sup> Due to the accelerating pace of technological change and the broader range of technical capabilities firms must possess, the minimum efficiency scale in high technology industries has increased rapidly and entry barriers exist. To solve this problem, pooling R&D resources to overcome scale indivisibilities and reach economies of scale can facilitate the development of high-tech products. As a consequence, several high-tech products with market potential such as biochemical products, Chinese computers and supercomputers, and so on can be jointly developed by firms from these three economies through R&D joint ventures. This would be a good starting point for further economic cooperation.

<sup>5</sup>See Chang (1990), pp. 146-48.



## **V. Concluding Remarks and Suggestions**

The recent surge of trade and investment on both sides of the Taiwan Strait through Hong Kong has been a natural consequence of such advantages as cultural ties, geographical proximity, and resource complementarity. This surge has drawn much attention to the increasing of economic integration of Taiwan, Hong Kong and China. However, it is misleading to think that the governments of these three entities intend to form a formal economic bloc.

After reviewing the economic prospects of a formal regional economic organization, and considering the views of the U.S. and the other Asian countries toward such an idea, we conclude that any organized form of economic integration, such as a free trade area or common market is premature and fraught with difficulties for the time being. However, the trend of increasing trade and investment among these three economies is irreversible. Therefore, the Taiwanese government must take a neutral attitude toward mainland Chinese trade and investment flows, in accordance with the comparative advantage principle. After all, the potential market of China, and the fact that closer economic cooperation can reinforce a more harmonious, stable relationship between Taiwan and China, should not be ignored.

As a consequence, at the present time, it is advisable for Taiwan to work toward eliminating trade barriers, abolishing restrictions on factor movements, and cooperating on developing high-tech products which require economies of scale in order to strengthen economic cooperation within this region.

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