

Asian Economic Integration: Challenges and Opportunities

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1. Introduction

East Asia has once again become the most dynamic growth center in the world economy. Japan is recovering from the decade-long economic stagnation, China is booming and dynamically transforming itself to an open market economy, India is also growing by pursuing liberalization and structural reforms, and other countries in the region are, by and large, demonstrating their strong resilience which was severely tested by the Asian crisis of 1997-98. With the overall recovery, economies in East Asia are integrating at a fast pace through private sector-led activities such as trade, foreign direct investment and financial flows.

The East Asian governments have embarked on various initiatives for “institutional cooperation” to support market-driven economic integration. First, the region’s trade officials have been putting significant efforts to forge closer ties through free trade agreements (FTAs) or economic partnership agreements (EPAs). Second, the region’s finance officials have initiated monetary and financial cooperation through the Chiang Mai Initiative, regional economic surveillance and Asian bond market development. Third, infrastructure officials have been working together to construct cross-border infrastructure with regulatory coordination. Fourth, the region’s heads of states have announced their intention to create an “East Asian Community” and to hold the first “East Asia Summit” meeting in Kuala Lumpur in December this year.

2. The Logic behind Various Institutional Cooperation Initiatives for Integration

What is the logic behind various initiatives for institutional cooperation to support economic integration? There are basically three reasons: first, the deepening of market-driven economic integration; second, the progress of European and American economic integration; third, the Asian financial crisis. Let me explain briefly each of these.¹

Deepening of economic interdependence. First, the most fundamental reason for the emergence of recent initiatives for institutional cooperation to support economic integration in East Asia is the deepening of regional economic linkages and interdependence.

East Asia has long enjoyed market-driven integration through trade and foreign direct investment (FDI), while embracing a multilateral liberalization framework under the GATT/WTO and, more recently, open regionalism through Asia-Pacific Economic Cooperation (APEC). The degree of

¹ More complete explanations can be found in: Masahiro Kawai, “East Asian Economic Regionalism: Progress and Challenges.” *Journal of Asian Economics*, 16:1 (February 2005), pp. 29-55.

regional economic integration through trade in East Asia has risen fast over the last twenty-five years. Intra-regional trade as a share of East Asia's total trade has risen from 35 percent in 1980 to 54 percent in 2003. This share is still lower than that in the European Union-15 (64 percent), but exceeds that of the North American Free Trade Area (46 percent).

The strong trade linkage in East Asia has been created by vigorous foreign direct investment (FDI) flows. Multinational firms in the major industrialized countries—the United States, Japan and Europe—have been the main investors in emerging East Asia. More recently, firms in the Asian newly industrialized economies (NIEs)—Korea, Taiwan, Singapore and Hong Kong—have been investing in ASEAN and China. The Asian NIEs' share in total FDI inflows in ASEAN9—excluding Singapore—is estimated to be 24 percent and their share in China 55 percent. Multinational corporations have set up regional production networks and supply chains by locating different sub-processes in different countries based on comparative advantage—relative factor proportions and technological capabilities. This strategy has stimulated vertical intra-industry trade in industrial materials, parts, components, semi-finished and finished products within East Asia, thereby making East Asia a self-contained production base for the world.

Market-driven financial integration has also been underway as a result of the increased deregulation of the financial system, opening of financial services to foreign institutions, and liberalization of the capital account in East Asia. Active commercial bank loans and portfolio investment flows have begun to link the economies in the region financially. Financial integration has yet to deepen through greater policy efforts to further deregulate impediments to the market based functioning of national capital markets and to harmonize market infrastructure and regulatory frameworks. As a result of market-driven economic integration, macroeconomic interdependence within the region has become stronger. For example, real macroeconomic activities—growth rates of real GDP, real private consumption, and real fixed investment—of Japan, Korea, Taiwan, Singapore, Malaysia and Thailand are highly correlated with each other, while they are not strongly correlated with those of the United States or Europe. The deepening of economic linkages and interdependence calls for institutional cooperation to manage such links and interdependence.

European and American regionalism. Second, there has been an increasing recognition in East Asia that the region should play a greater role in the global economy as one of the three poles together with the European Union and the Western Hemisphere. The region shares a certain sense of concern that due to the steady progress of integration both in Europe and the American Continent, the two giant blocs might dominate the rule-setting in the global economy while marginalizing the role and weight of East Asia. This might put East Asia in a disadvantageous position in global competition and multilateral negotiations. East Asia, therefore, has come to the view that to play an important role in global economic management, it must step up its own process of integration and increase the region's voice in the global scene.

Facing the slow progress of the WTO/Doha liberalization process and the perceived diminishing effectiveness of the APEC process, this issue has become particularly urgent in trade policies. Governments and business people in East Asia now believe that the region's firms should exploit scale economies and dynamic efficiency gains through FTAs and EPAs by securing a bigger market within their own region. These are expected to raise both productivity and international competitiveness. From this perspective, East Asian economies are now promoting harmonization of trade and investment rules, various standards and procedures, and certain domestic policies that can affect cross-border trade and investment.

Asian financial crisis. Third, the Asian financial crisis of 1997-1998 has taught the important lesson that East Asia needs to strengthen monetary and financial cooperation in order to maintain regional financial stability. The global initiative to strengthen the international financial system in this regard has been unsatisfactory. The national efforts to strengthen individual economic fundamentals, to

reduce the likelihood of home-grown crises and to increase domestic resilience to crises and contagion—particularly through adopting the internationally recognized standards and codes—take time to bear fruit. Hence, the general sentiment in East Asia has been that the region must establish its own “self-help” mechanism for prevention and management of possible crises in the future. Such cooperation should include information exchange and policy dialogue, creation of a regional liquidity support arrangement, joint development of a balanced financial sector at the national and regional level, and collective policymaking in certain critical areas such as exchange rate policy coordination.

Since regional financial stability is a basis for global financial stability, effective regional financial cooperation is an obvious benefit not only for the regional economies but also for the global community. In this sense East Asian regional financial cooperation contributes to the stability of global finance.

3. Current States of Regional Cooperation for Economic Integration

Now, I would like to explain the current states of regional cooperation for economic integration.

Regional trade arrangements. On regional trade arrangements, the ASEAN member countries were the first in East Asia to embark on a free trade agreement—called the ASEAN Free Trade Agreement (AFTA)—in 1992. Since then, the member governments have been making strenuous efforts to remove import quotas and lower tariffs in their intra-ASEAN trade. The advanced six members had reduced their tariffs to 0-5 percent by 2002 and all members continue their efforts with the aim of making ASEAN a tariff free area by 2015 and transforming it into an economic community—an area with no impediments to movements of goods, people and capital—by 2020.

Recently, many other governments in East Asia have promoted bilateral and multilateral trade arrangements in the region. Notably, Japan implemented a bilateral economic partnership agreement (EPA) with Singapore in November 2002. In response, China began official negotiations with ASEAN to complete a free trade agreement (FTA) by 2010 with advanced ASEAN members and by 2015 with less advanced members. They have already implemented the “early harvest” measures since January 2004 and made an FTA for goods trade effective in January 2005. Japan and ASEAN began negotiations in April 2005 on an EPA. Korea has also begun a similar negotiation with ASEAN to be completed by 2009. Japan has almost concluded bilateral negotiations for EPAs with Malaysia, the Philippines and Thailand, is negotiating EPAs with Korea and Indonesia. In this sense, there have been domino and bandwagon effects among Japan, China and Korea in their competitive drive for regional FTAs/EPAs with ASEAN. Recently, India and Australia are joining in this wave.²

Table. Liberalization Timeframe

Agreements	For Developed Countries	For Developing Countries	
		For Advanced Six Members	For Other Four Members
APEC	By 2010	By 2020	By 2020
ASEAN	--	By 2002 (0% tariff by 2010)	By 2007 (0% tariff by 2015)
		Economic community by 2020	
ASEAN/China	--	By 2010	By 2015
ASEAN/Japan	--	By 2012	By 2017
ASEAN/India	--	By 2011	By 2016

² East Asia’s move to regional trade arrangements symbolizes a change in its long-standing policy of pursuing trade liberalization only in a global or trans-regional framework based on the WTO and APEC—apart from ASEAN. The region has decided to shift its trade policy to a three-track approach based on global (WTO-based), regional (within ASEAN+3), and bilateral liberalization.

The next stage is to create an East Asia-wide FTA, including ASEAN, China, Japan and Korea, by integrating the web of various regional FTAs/EPAs. To make the task easier, it would be preferable to design from the outset regional FTAs in a coherent way in terms of rules of origin, exclusion lists and liberalization timeframe. In addition, the regional economics can benefit through harmonization of various standards, procedures, rules and regulations—in the industrial, safety, infrastructure, environmental areas as well as movement of people—to facilitate further cross-border trade and investment. Convergence towards common, low tariffs and identical rules and standards would be highly desirable.

Monetary and financial cooperation. ASEAN+3 members have embarked on initiatives for regional financial cooperation. These initiatives are based on three major pillars: (a) creation of a regional liquidity support facility through the Chiang Mai Initiative; (b) introduction of policy dialogue and economic surveillance; and (c) development of Asian bond markets.

First, the Chiang Mai Initiative (CMI), is designed to reduce the risk of liquidity shortage and limit regional currency attacks, contagion and crises. The Asian financial crisis highlighted the importance of establishing an effective financing facility so that the economies in the region can prevent currency crises or respond effectively to crises once they occur in a world of increased financial globalization. Under the CMI, the network of 17 bilateral currency swap arrangements among central banks totaling \$52.5 billion has been created. In May this year, the ASEAN+3 Finance Ministers agreed to make the CMI it more effective and disciplined.³

Second, regional policy dialogue and economic surveillance involve assessment of macroeconomic and financial conditions and policies of member economies, identification of vulnerable aspects of the economy and finance, and recommendation of appropriate policy responses. This process requires frank and candid exchanges of views and policy discussions among member economies, and is intended to induce good policies through peer pressure. The most notable surveillance process is that of ASEAN+3 finance ministers, whose primary focus is on global, regional and national economic surveillance, macroeconomic and financial risk assessment, and policies to reduce such risks. Steps have been taken for monitoring short-term capital flows and developing a regional early-warning system to detect regional financial vulnerabilities, with a view to preventing financial crises in the future. The next stage will be to further strengthen the CMI and economic surveillance. We may need a more permanent commitment of pooling the region's foreign exchange reserves for crisis lending and management, and we may need a centralized, professional organization that manages the CMI operation, conducts economic surveillance and prepares comprehensive policy assessments. Once these are done, the region may have effectively created a *de facto* Asian Monetary Fund (AMF).

Third, initiatives have been taken to develop Asian bond markets in view of the need to channel a vast pool of savings to long-term investment for growth and development within the region. This effort reflects the recognition that the financial system in East Asia has been too dependent on bank financing domestically and on foreign-currency financing externally and, hence, needs to be strengthened through the development of national and regional bond markets. Development of

³ This includes: (i) integrating the CMI with an enhanced economic surveillance process; (ii) adopting a collective decision-making process for CMI activation as a first step toward multilateralization; (iii) increasing the size of the existing swaps by up to 100 percent; and (iv) doubling the size of the swaps that could be withdrawn without an IMF program from 10 percent to 20 percent. One of the important features of the current CMI BSAs is that members requesting liquidity support can immediately obtain short-term financial assistance for the first 20 percent of the facility. The remaining 80 percent is provided to the requesting member under an IMF program.

well-functioning, local-currency denominated bond markets is useful in reducing incentives to rely excessively on bank financing and/or external borrowing. It thus mitigates the “double mismatch” problem of international capital markets—i.e., of currency and maturity mismatches. The central bank process has established Asian Bond Funds (ABF-1 and ABF-2) to stimulate the demand side, and the finance minister process has undertaken the Asian Bond Market Initiative (ABMI) to stimulate the supply side of local currency-denominated bond markets. Ongoing efforts also include measures to strengthen infrastructure for bond market development—including the establishment of a regional clearing and settlement system, creation of a regional bond guarantee agency, and the strengthening of regional rating agencies—and to encourage bond issues denominated in a basket of Asian currencies.

Finally, despite the potential benefit of intra-regional exchange rate stability—and ultimately the creation of a single Asian currency—progress has not been made on exchange rate policy coordination. The creation of a single currency is admittedly a long-term agenda, given that it took fifty years for Europe. The region may begin with an exchange rate arrangement that ensures intra-regional rate stability without requiring a high degree of policy coordination. Once Asian countries achieve financial openness, currency convertibility and economic convergence, they would be ready to begin full-fledged policy coordination for intra-regional exchange rate stabilization. These attempts may eventually lead to an Asian single currency.

East Asian Economic Community. East Asian countries have also been coordinating policies in other areas, including the construction of cross-border infrastructure (highways, railways, internet telecommunication, etc.), maintenance of energy security, protection of environments, containment of communicable diseases and adoption of collective response to Tsunami. One of the recent, most significant developments is the agreement by the ASEAN+3 Leaders in Vientiane in November 2004 that they would make efforts to form an “East Asian Community” and hold an “East Asian Summit” for this purpose. A combination of an East Asia-wide FTA, a mechanism for regional financial stability and collective action to provide various types of regional public goods would constitute an important component of the “East Asian Community”.

4. Challenges Ahead

Institutional cooperation for East Asian economic integration faces several challenges. First, economies of East Asia are diverse and heterogeneous in terms of economic systems, per capita incomes, stages of economic and institutional development, and human and social conditions. Diversity and heterogeneity imply that low-income countries—where market infrastructure is insufficiently developed and institutional capacities are limited—will be slow in trade, investment and financial liberalization and market opening and, hence, will not be able to integrate themselves quickly with the rest of East Asia. This constitutes an obvious impediment to economic integration for the whole of East Asia. For the governments to take joint action at the regional level, there must be substantial economic convergence. Assistance by developed countries—including Japan—and by multilateral development banks—such as the World Bank and the Asian Development Bank—can play an important role in helping low-income countries overcome unfavorable initial conditions for economic development.

Second, members of East Asia are also diverse in political systems and in cultural and religious traditions, without shared history of political integration under a hegemonic power. As a result, establishment of a common value, mutual trust or strong political will for economic integration is one of East Asia's most challenging issues. A brighter side is that East Asian economies do share the view that “peace and security” is the basis for sustained economic growth and development. From this perspective, Japan, China and many other countries in the region have so much to gain from their good political relationship, without which the region cannot make substantial progress on economic

integration.

Third, the region needs to maintain openness to the rest of the world—particularly North America and Europe which remain important as markets for final products and sources of risk capital and innovative ideas. The region must continue to embrace the WTO as a global institution that can reduce cross-bloc impediments to trade and investment flows. It is in the best interest of East Asia to regard the WTO principles as the basic infrastructure for international trade rules and achieve trade and investment liberalization by going beyond the commitments under the WTO. Similarly, the region needs to complement the IMF by ensuring regional financial stability, without which global financial stability cannot be achieved. At the same time, East Asia must make efforts to increase their voice in these global institutions for global economic management.

5. Conclusion

My basic point in this presentation is that East Asian economic integration has been deep, comparable to that of Europe and North America, and largely market-driven. But the institutional support to such integration has been limited. In this sense, East Asia has great potential for further economic integration through various types of institutional cooperation. These include: creation of an East Asia-wide FTA, establishment of a stronger mechanism for regional financial stability, relative stability of intra-regional exchange rates and provision of various types of regional public goods, all of which would be a basis for a future “East Asian Community”.

Another point of my presentation is that due to the differences in political and economic systems, the pace of institutional cooperation for East Asian economic integration may be slow and the multi-speed approach may be needed. For this reason, its structure ought to be flexible and open until a stronger political and economic convergence is achieved. For the time being, market-driven integration continues to deepen and the region can still gain much by pursuing institutional cooperation to a maximum extent in all key areas, namely, trade and investment, money and finance, and other regional public goods.

Finally, the idea of creating a single currency in East Asia may appear far-fetched and unrealistic at this point, but it can articulate a long-run strategy for regional economic integration.