CHAPTER 2

Regional Economic Integration in East Asia: Development, Cooperation, and Prospect

2.1 Introductory Overview

Since the second half of the 1980's, three major regions in the world economy, namely, the European Union (or the EC at that time), North America, and East Asia, have made progress in regional economic integration. The most successful regional economic integration can not be any region but the European Union. The European Union is the one true trading bloc in the world at this moment. The evidence from European integration points out that, as the region has moved closer together, trade and investment have grown most quickly among neighboring countries. Finally, it yields benefits rather than costs to the region. Hence, the question naturally pops up as to whether the east Asian countries can, or will, forming its own trading blocs or regional economic integration.

Interest in the establishment of East Asian regional economic integration has increased in a recent year. Regional economic integration in East Asia takes place at various levels for various reasons by various factors. There are several factors, which explain such trend. First is a solid background of deepening regional economic interdependence among Japan, China, and Asian neighbors, and it results in the form of multi-tier interdependence among these economies. Second, there is the current heavy intensive direct investment within the region, which have made the region more integrated. Third, high economic growth in the region, particularly in China and ASEAN, in the 1980s, Asian exports have increased, and it makes Asia became the most significant and most rapidly growing market. Furthermore, FDI from big country like Japan and NIEs are major driving forces for regional economic integration in East Asia.

East Asia is comprised of the extremely diverse countries in the region. This region can be named as "Unity in diversity" by considering their history, tradition, religion, politic, and economy. This outstanding characteristic would provide the smooth road for East Asia regionalism. Hence, the next section will concentrate on an overview of selected nine East Asian countries for a clearer point of view.

2.2 An overview of selected nine East Asian countries[1]

In economic aspect, there are number of macroeconomic variables, which can depict the overall performance of the country such as Gross Domestic Product (GDP), the growth rate of GDP, inflation, current account balance, budget balance, international reserves, external debt, unemployment rate, exchange rate, and others. Anyhow, this study will focus mainly on GDP, GDP growth rate, inflation, current account balance, and exchange rate.

GDP growth rate usually measures the overall economic performance. Country with good economic performance usually holds relatively high GDP growth rate. *Inflation* measures the level of prices of goods and services in the economy and indicates country's economic stability. Therefore, country with high rate of inflation is likely to be economic instability. *Current account balance* measures the economy's trade in goods and services with others. *Exchange rate* is the price of one currency in term of another countries. It also reflects the country's real economic condition. Exchange rate fluctuation is a major source of uncertainty in international business since it affects both trade and investment of the country.

Ever since 1980, East Asian economies – Japan, China, Taiwan, South Korea, Singapore, The Philippines, Indonesia, Malaysia, and Thailand – have enjoyed worldwide attention. Through the process of export-led development, these Asian economies have become the growth center of the world's fastest-growing region. It is not only a matter of global concern but also country-by-country basis. Japan was the first East Asian economic miracle, and followed by four little dragons – Republic of Korea, Hong Kong, Taiwan, and Singapore. And in the 1980s, Thailand and Malaysia also brought a miracle into the East Asian region. On the other hand, there are also countries such as Myanmar and Vietnam whose economies are still lagging behind their neighbors.

Intra-regional trade has also increased sharply from 1970 to 1986 among ASEAN, NIEs, and China. From 1986 to 1992, the trade between Japan and other Pacific Rim states has almost doubled. The trend, has thus been one of a continuation of growth, rapid industrialization, and increased intra-regional trade. The trend now is as strong as ever, and shows no sign of decay, and this indicates the desire and a possibility for deeper regional cooperation.

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[1] The individual country's economic overview can be found in Appendix A.

2.3 Descriptive Analysis

2.3.1 Economic Integration through the Theory of Interdependency

Trade Interdependency

The "Trade Matrix" can provide valuable information on the economic interdependency between countries, and in this case, it will be employed to observe and analyze the relationship and the interdependency of the selected Asian countries. Naturally, countries that have close economic relationships are more inclined to form a better economic integration unit than those countries that do not have close economic ties.

Below is an exhibition of the trade relation for the selected Asian countries, in the selected years, the full trade matrix can be found in the Appendix.

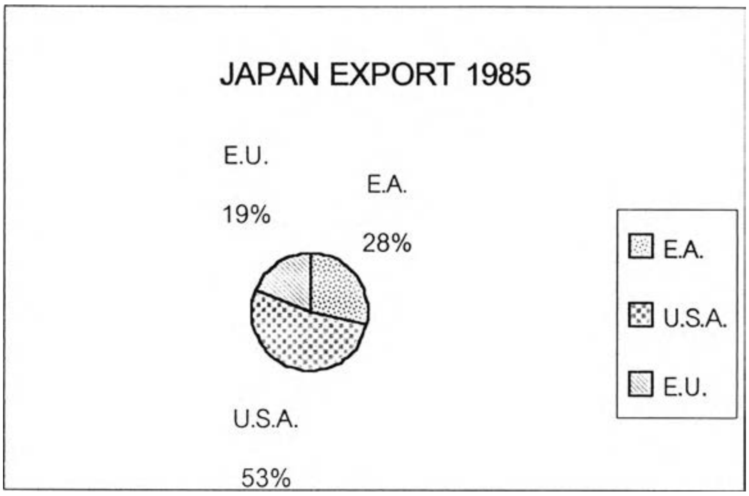
Table 2-1 (a) Japanese Export to destination countries

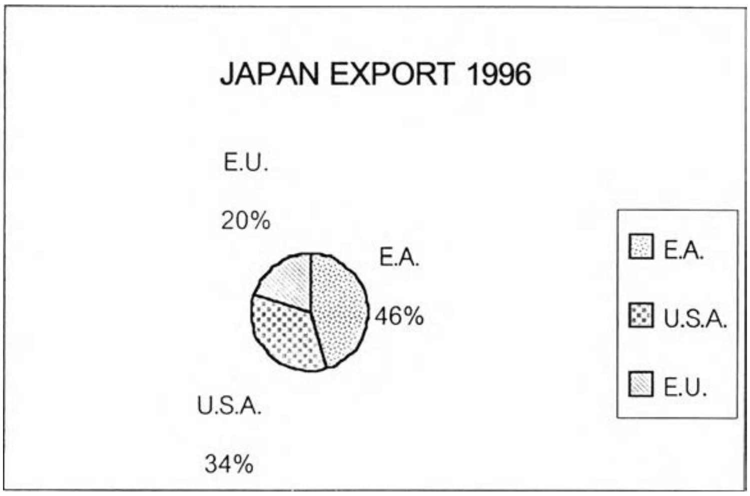
JAPAN	1985	1996	1998
CHINA	12590	21827	20675
INDO	2191	9059	4966
KOREA	7159	29369	16713
MALAY	2184	15341	9986
PHI	946	8397	7519
SING	3893	20800	14845
TAI	5068	25986	33404
THAI	2047	18301	10041
E.A.	36078	149080	118149
U.S.A.	66684	113174	119378
E.U.	24285	66313	75470

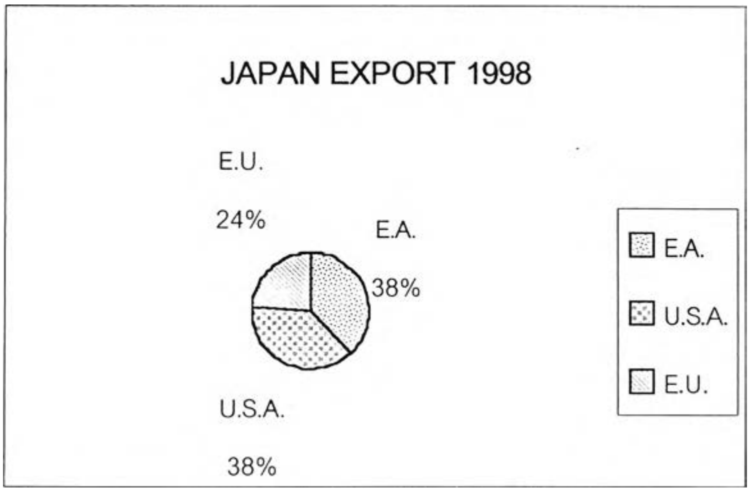
Table 2-1 (b) Japanese Export to major areas

JAPAN	1985	1996	1998
E.A.	36078	149080	118149
U.S.A.	66684	113174	119378
E.U.	24285	66313	75470
TOTAL	127047	328567	312997

Exhibit 2.1 Japanese Export to destination countries in 1985, 1996, 1998







From the exhibition above, Japan was taken as an example. The result shows that Japanese export to East Asian countries (E.A. stands for East Asian countries: China, Indonesia, South Korea, Malaysia, The Philippines, Singapore, Taiwan, and Thailand) in 1985 was about 28%, to European Union countries was 19%, and to U.S.A. was 53%. Comparing with 1996, Japanese export to East Asian countries increases remarkably to 46% almost double what it was 10 years earlier. Japanese export to European Union countries was about 20%, to U.S.A. was about 34%, which drop from 53% in 1985. After the crises occurred in 1997, the Japanese export to East Asian countries drop slightly to 38% due to the fact that the Asian countries' purchasing power declines.

On the import side, in 1985 Japanese import from East Asian countries was about 46%, from European countries was about 17%, and from U.S.A. was about 37%. Comparing with 1996, her import from East Asian countries was slightly increase to 48%, from U.S.A. was slightly drop to 32%. After the crises occurred, the Japanese import from East Asian countries drop only 1% from 1996. This shows the strength of Japanese economy.

In case of other countries in East Asia, they present the same trend as Japan case in that there is an increasing in trade relation or trade interdependence among them. The result can be found in trade matrix, which is shown in Appendix D.

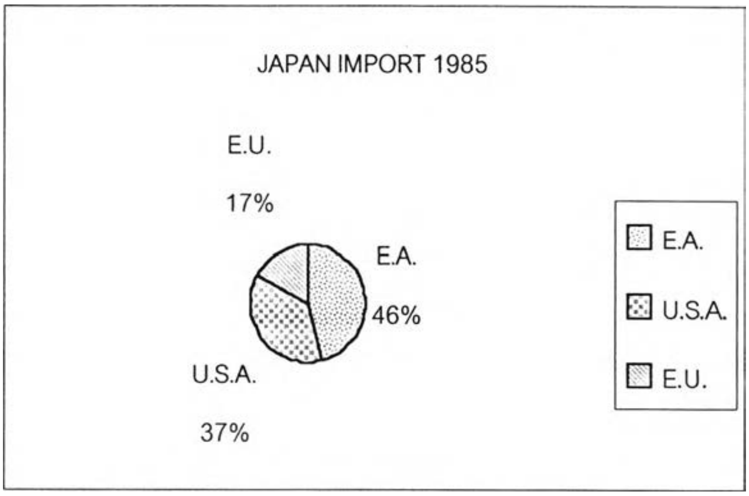
Table 2-2 (a) Japanese Import from destination countries

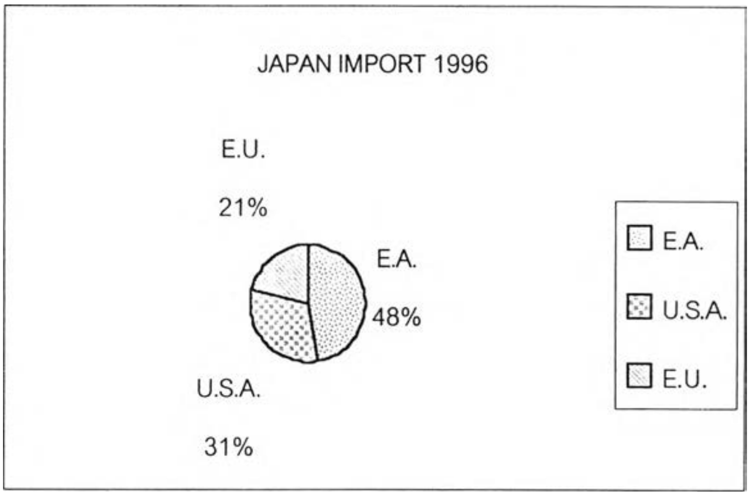
JAPAN	1985	1996	1998
CHINA	6534	40405	36929
INDO	10192	15223	11165
KOREA	4144	15980	12642
MALAY	4347	11762	9069
PHI	1252	4511	4577
SING	1607	7332	4991
TAI	3416	14968	13363
THAI	1035	10266	8361
E.A.	32527	120447	101097
U.S.A.	26099	79897	67089
E.U.	12233	54313	43388

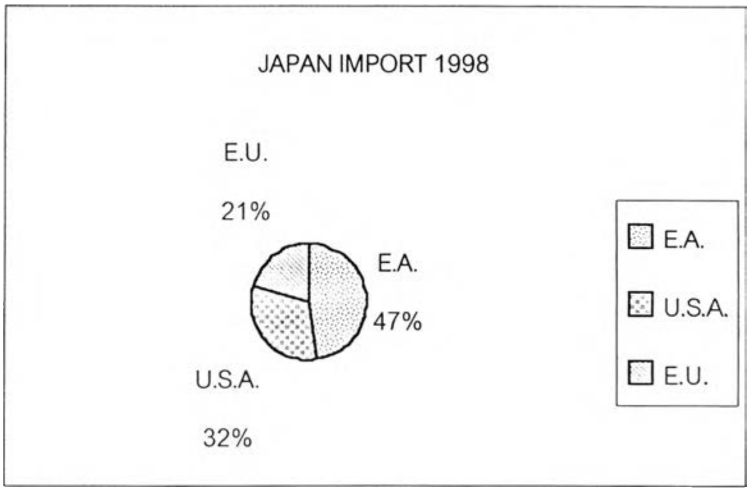
Table 2-2 (b) Japanese Import from major areas

JAPAN	1985	1996	1998
E.A.	32527	120447	101097
U.S.A.	26099	79897	67089
E.U.	12233	54313	43388
TOTAL	70859	254657	211574

Exhibit 2.2 Japanese Import from destination countries in 1985, 1996, 1998







From the trade matrix (in the Appendix D), it is evident that over the last 15 years, there has been an increased in the intra-regional trade in the East Asia region. There are many factors that have contributed to that increase. For example, in case of China, the Open Door Policy is an instrumental factor that contributed to the increased in trade relation with her neighborhood. The cross-border trade is always more beneficial and profitable, it also saves valuable time. Additionally, there is an increasing in practicing on the lowering the regional tariff rates. Furthermore, in light of prospective increased protectionism from the United States- correcting its trade deficit and the EC- integrating their economies in 1992; prospective markets for exports from the Pacific countries will be shift to Japan, Asian NIEs and China, which are stimulated by domestic expenditures and becoming increasingly liberal in international trade. In addition to industrial link ups, direct investment could also be a stimulus to increased trade interdependence. Most Japanese investment in ASEAN and Taiwan is concentrated in export-oriented industries. The increase in trade within the region was also assisted by the adoption of export-led growth by countries in the region.

From the exhibition and trade matrix in the Appendix D, it can also be observed that during the financial crisis outbreak in 1997, most of the trade statistics for most of the country shows a declining trend. There are only a handful of cases where there were increases, but these increases are only modest increases anyway. For example, Thailand, where the crisis was set in motion, her export to China in 1997 was US$ 1,744 million, which rose to US$ 2,025 million in 1998, but her import from China in 1997 which amounted to US$ 2,260 million dropped to US$ 1,791 million. Her trade statistics also suffered a similar trend in the case of Japan, where in 1997 Thailand exported US$ 8,733 million, which was already lower than 1996's US$ 9,373 million, which further fell to US$ 7,571 million following the financial crisis. Thailand's import from Japan in 1996 was US$ 20,449 million, which fell to US$ 16,165 million in 1997, and declined to just US$ 11,164 million post-crisis. Interestingly, if we were to look at the trade matrix between Thailand and Malaysia, we would find that in 1996, Thailand exported US$ 2,014 million, which rose to US$ 2,483 million in 1997, and increased further to US$ 2,529 million following the crisis year. On the import side, however, the trend was an opposite one, with the value declining from 1996's US$ 3,606 million to US$ 3,019 million in 1997, and declined further to US$ 2,934 million in 1998.

The overall picture of the trade matrix in Asia shows that there have been strong trade relations between the selected Asian countries, which is a good sign for a solid foundation for an Asian economic integration, and that although the figures suffered a setback in 1997, during the Asian financial crisis, the region look strong enough to be able to bounce back. And the trade matrix shows an impressive evidence that it is unlikely the trade relations between the selected countries will suffer any more damages. But in order for the Asian economic integration to regain momentum, the leaders of the Asian countries have to take this opportunity, when the attitude towards an economic integration has shifted to a more positive one, and the environment is just right to achieve such a feat. The timing is as good as it will ever get, and the feeling is there for it to enjoy success, but there are a lot more works to be done, and if an Asian economic integration is to be achieved, something has to be done now. The trade matrix can only show that the potential for success is good, and for that potential to be realized, it remains firmly in the hands of the Asian leaders.

2.3.2 Monetary Integration through the Optimum Currency Area Theory.

The Optimum Currency Area Index represents the measurement of convergence among the selected countries in a currency area, and it is used to predict the best participants in an economic integration. The Optimum Currency Area (OCA) theory has a set of preconditions, which if a particular country can match these, would mean that they are the best-suited countries for a currency area, and possibly the founding members of a monetary union. The main preconditions for the OCA index includes;

- Degree of Factor Mobility,
- Degree of Openness,
- Degree of Production Diversification, and
- Degree of Inflation rate.

These preconditions act as a kind of rule to screen out unsuitable countries in order to prevent any problems in the future, and as stated earlier, the more preconditions a country can achieve, the easier it will be for a monetary union to be created.

<u>Degree of Factor Mobility</u>

For any monetary integration to succeed, special attentions need to be given to the financial capital market, and a flexible exchange rate is not desirable, because an integration at such a high level will automatically address the account balance deficits, and decrease the reliance on exchange rate because in such an integration, a fluctuation in the interest rate, no matter how small will trigger movement of capital, and that in itself will help the account balance situations. Hence, naturally, the success of a monetary integration need a strong, connected financial capital market, and such an arrangement can be stimulated by the abolishment of laws that limit and restrict capital mobility, and the easing of capital control in the potential.

In the case of Asia, there are still quite a lot of capital controls in most countries, which is an obstacle to growth and damages the true mechanism of the economy because the domestic financial institutions will develop very slowly due to the lack of competitiveness. The IMF had played an instrumental role in liberating the capital control in Asia. The more rigid the capital control is, the more difficult to set up a monetary union. Hence, as the Asian financial market becoming more liberalized the dream of an Asian monetary union becomes more and more achievable. To further enhance this fact, Asia is also driven by other common factors, both internal and external, such as the similarity in the investment environment, and the increased in the intra-regional foreign direct investment.

Countries liberalize international capital flows in order to raise economic efficiency and enhance growth potential. Many countries have responded to external pressure (notably from the United State) by open their money and capital markets and removing foreign exchange controls. For example, South Korea submitted a schedule of capital liberalization in preparation for admission to the OECD. China is liberalizing trade and foreign exchange regulations in expectation of securing membership in the World Trade Organization (WTO).

Asian stock markets are also being opened to the outside world. South Korea began to open its securities market in January 1992, when it permitted non-residents to invest directly in Korean stocks as part of its plan to promote the gradual expansion of its capital market. Taiwan also approved the acquisition of local stocks by foreign institutional investors in 1991 subject to certain conditions. In China, which is moving rapidly along the path toward a market economy, stock exchange was set up in Shanghai in December 1990, followed by a second one in Shenzhen in July 1991. Investment in Chinese stocks by non-residents has been facilitated with the listing of more and more Chinese enterprises in Hong Kong and New York. Asian countries that are less restrictive toward investment in their stock markets by foreigners, such as Hong Kong, Singapore, Malaysia, Thailand, The Philippines, and Indonesia, have tried to further enhance their attractiveness to foreign investors by strengthening their supervisory systems and promoting computerized transactions.

The deregulation of foreign direct investment in Asian countries is also well under way. China's acceleration of its reform and open door policy since 1992 has prompted other Asian countries to focus on improving their investment environments. As a general trend, their policies toward foreign capital have begun to converge. China has made great progress in opening more regions as well as industries and sectors to foreign investors. ASEAN nations have responded to these moves by China by taking steps to encourage investment by foreign companies. Indonesia has basically removed restrictions on investment by foreign companies, requirements concerning capital movement, and regulations governing minimum amounts of investment.

The rapid increase in direct investment in Asia since the beginning of the 1990s was a major source of funds supporting Asia's economic development. As Asian stock markets develop and become more and more open to foreign investors, stock investment has become an important channel for the inflow of funds into Asia.

Asia, after all that has been said and done, has a great potential to form a monetary integration, because of favorable environment and central institutions that are quite well prepared to respond to such ambitious undertaking. With further capital control liberalization on the agenda, the prospect is looking very bright indeed. Although the region's attractiveness to foreign investors have declined somewhat after the financial crisis, a stabilization measure that covers the whole region will easily give confidence back to these investors, and one of the best method to achieve this is undoubtedly, through a monetary integration.

Degree of Openness.

For any economic or monetary integration to be successful, a common currency is essential, because once labor can move freely between countries, a common currency will help to stabilize the price of goods. The more open a country, the less the fluctuation of the exchange rate, and this will play a key role in the stabilization of the country's trade. Big countries are the countries that import less, and produce more domestically, in comparison with the domestic consumption, and hence need to have a restriction on domestic prices to stabilize the economy. But in the case of a small country, a fixed exchange rate is necessary, as it will help foreign investment and capital mobility from abroad, this is because the small country is vulnerable to external shocks, and depreciation of the currency does not always stimulate exports, and the chance of investment will be affected if the exchange rate is flexible. Hence smaller countries will benefit more from the fixed exchange rate regime.

Countries with higher degree of openness will receive better benefits. To prevent external shock totally damaging the economies of the member countries, a fixed exchange rate for the monetary union should be set in a limited sphere.

Degree of Product Diversification.

According to Kennen, the degree of product diversification is an important indication of the extend of the success that a monetary integration will enjoy. He feels that the optimum currency area would be best fit for an area that have a good product diversification, because when the surplus demand for a product decreases, the unemployment rate would not suffer so severely because the drop in demand is only a small portion in a diversed labor market. On the contrary, in the case of limited product diversity, when an external shock occurs, the damage would be full on, with nothing to absorb the shock.

Countries with low product diversification will benefit more from a fixed exchange rate, because if external shock occur, it will affect the profit from the country's exports and cause a fluctuation, which will lead to more problems such as continuous account balance deficit that will lead to a weakening of the currency, which then need to be depreciated, and will harm the investors' confidence in that country's financial system.

Degree of Inflation Rate.

Countries with similar inflation rate will have a more successful chance of forming a monetary union. In the case where the countries have a different levels of inflation rate, countries with high inflation rates will try to protect their competitiveness by using the exchange rate as a tool to lower the inflation rate. But in a monetary union, member countries have to peg their inflation rates together, and no country will be able to freely manipulate their exchange rate to solve their internal problem. Any changes will affect the union so no country is on their own, and are not independent to do or adopt measures by themselves.

So before the potential members could consider forming a monetary union, these countries should work to achieve an inflation rate convergence. Establishment of a regional central bank to control the mutual monetary policy can help the process imminently, and the liberalization of the potential members' economies, and allowing the market mechanism to operate to its fullest potential, as well as having laws and labor related measures to keep the countries' levels together will help in the convergence process.

Table 2-3 : Inflation Rate (Change in Consumer Price Index)

Year	CHI	INDO	JAP	KORE	MALAY	PHI	SING	TAI*	THAI
1975		19.1	11.8	25.3	4.5	6.8	2.5	5.2	5.3
1976		19.9	9.4	15.3	2.6	9.2	-1.8	2.5	4.1
1977		11	8.2	10.2	4.8	9.9	3.2	7	7.6
1978		8.1	4.1	14.5	4.9	7.3	4.9	5.8	7.9
1979		16.3	3.8	18.3	3.7	17.5	4.1	9.8	9.9
1980		18	7.8	28.7	6.7	18.2	8.5	19	19.7
1981		12.2	4.9	21.3	9.7	13.1	8.2	16.3	12.7
1982		9.5	2.7	7.2	5.8	10.2	3.9	3	5.3
1983		11.8	1.9	3.4	3.7	10	1.2	1.4	3.7
1984		10.5	2.2	2.3	3.9	50.3	2.6	-0.04	0.9
1985		4.7	2	2.5	3	23.1	0.5	-0.2	2.4
1986		5.8	0.6	2.8	7	0.8	-1.4	0.7	1.8
1987	7.2	9.3	0.1	3	3	3.8	0.5	0.5	2.5
1988	18.7	8	0.7	7.1	2.6	8.8	1.5	1.3	3.8
1989	18.3	6.4	2.3	5.7	2.8	12.2	2.3	4.4	5.4
1990	3.1	7.8	3.1	8.6	2.6	14.1	3.5	4.1	6
1991	3.5	9.4	3.3	9.3	4.4	18.7	3.4	3.6	5.7
1992	6.3	7.5	1.7	6.2	4.8	8.9	2.3	4.5	4.1
1993	14.6	12.5	1.3	4.8	3.5	7.6	2.3	2.9	3.4
1994	24.2	9.6	0.7	6.2	3.7	9.1	3.1	4.1	5
1995	16.9	9	-0.1	4.5	5.3	8.1	1.7	3.7	5.8
1996	8.3	6.6	0.1	4.9	3.5	8.4	1.4	3.1	5.8
1997	2.8	11.6	1.7	4.4	2.7	5.1	2	0.9	5.6
1998	-0.8	57.6	0.6	7.5	5.3	9.7	-0.3	1.7	8.1

Source: International Financial Statistics Yearbook 1998 and 1999

* Taiwan: Taiwan Statistical Data Book 1999

From the table, we can see that the inflation rate varies quite a lot among the selected Asian countries, for example, interestingly in 1985, the inflation rates ranged from a low of negative 0.2 percent of Taiwan, 0.5 percent in Singapore, 2 percent in Japan, 2.4 and 2.5 percent in Thailand and Korea respectively, 4.7 percent in Indonesia, and an amazing 23.1 percent in the Philippines. 1996 was the year that the inflation rates of all the selected countries seem to be in a convergable range, a lot better than the 1985's rates; 0.1 percent in Japan, 1.4 percent in Singapore, 3.1 and 3.5 percent in Taiwan and Malaysia respectively, 4.9 percent in Korea, 5.8 percent in Thailand, Indonesia's 6.6 percent, and China's 8.3 percent – down from the 1995's rate of 16.9 percent. The inflation rate than showed a major shift in 1998, a year after the financial crisis, when Indonesia posted a record 57.6 percent inflation rate, Thailand's 8.1 percent was also the highest it had been since 1982, the Philippines' 9.7 percent, Korea's 7.5 percent, 5.3 percent in Malaysia, and 1.7 percent in Taiwan. The same year, Singapore once again posted a negative inflation rate of 0.3 percent, only the second time after 1986's negative 1.4 percent, Japan's inflation rate dropped from 1.7 percent to 0.6 percent, and China recorded its first negative inflation rate of 0.8 percent. From this statistics, it is clear that going by the inflation rate, the convergence of the selected Asian countries' inflation rate is still a far-fetched ambition. But with the cooperation of the Central Banks of the member countries over the past few years, the inflation rate gap seems to have decreased somewhat.

2.4 Conclusion

Observing the crucial statistics, it is clear that there is a positive sign that an Asian economic integration can be achieved. Asia, although quite diverse, due to the differences in the nature of each country, can accomplish this goal with more intense cooperation between the potential member countries. On the trade side, there seem to be few problems, because the countries are already trading with each other on a large scale, and the trend seems to be on the increase, as all the other Economic Union, be it the European Union, or the NAFTA are looking more and more towards intra-regional trade. On the finance side however, the prospect is not as bright. More negotiations need to be done, more cooperation and discussion are also needed to address issues such as the ridding of tariffs rates, as well as the inflation convergence issues. More cooperation from the potential members' Central Banks is also needed to observe and keep a close watch on the inflation rates, and exchange rates.

But one thing that is certain is that although an Asian economic integration is an achievable target, the potential members need to be selected carefully. The potential members need to have the right characteristics, as well as meet all the preconditions for an integration, because if they do not meet these preconditions, they could hinder the progress of the integration. Furthermore, a strong regional institution will need to be established. It is also clear that if an Asian economic integration is to be achieved, countries outside the ASEAN grouping will need to play a role. Countries like China and Japan, who are the powerhouse of the region can act as the anchor for such a regional grouping because they are accepted and respected by the other potential member countries, and their economy is one of the strongest and most stable in the region. The need for a strong leader is evident from the fact that throughout the existence of ASEAN, they have discussed the possibility of an Asian economic integration had been discussed at length, but so far have not materialized. This may have been because all the members of ASEAN are similar in nature, economic wise, and do not have stand out leadership quality, hence the inclusion of Japan and China would ensure a more successful progress towards the goal of an Asian economic integration.