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Introduction

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Abstract
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1. Introduction

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1.1 OVERVIEW

Until the Asian crisis erupted in 1997 the East Asian economies pursued a multilateral approach to trade throughout the post-war period. In particular, Japan, China and South Korea were the world’s only major economies that had yet to conclude a free trade agreement (FTA). The sole exception was the Association of South-East Asian Nations (ASEAN), which had been planning an FTA for several years. In recent years, however, a new regionalism has begun to emerge in East Asia that represents a clear break from the region’s strong history of multilateralism. The countries of East Asia have been giving more attention to ways of expanding intra-regional trade that include: the establishment of regional trade agreements (RTAs) such as ASEAN+3; plans to establish a free trade area involving the economies of ASEAN and China; as well as moves towards bilateral trade agreements (BTAs).

A number of bilateral agreements have been concluded and are being negotiated or studied. Singapore, the most trade-reliant ASEAN member, started the ball rolling by signing FTAs with 17 countries including New Zealand (2000), Japan (2002), Australia (2003), the United States (2003) and Jordan (2004). Singapore is currently negotiating/laying the groundwork for similar bilateral FTAs with Canada, India, Korea, Mexico, Sri Lanka, Bahrain, Egypt and Taiwan. Thailand is also one of the leading proponents of the creation of bilateral FTAs. Thailand signed an FTA with China in 2003, and signed a Closer Economic Relations (CER) Framework Agreement with India in 2003 and a Closer Economic Relations and free-trade agreement (CER-FTA) with Australia in 2004. Thailand has also negotiated similar FTA deals with the United States, Japan, Chile, New Zealand, Papua New Guinea, Peru, Bahrain and Australia. It also aims to reach bilateral FTAs with
countries like Bangladesh, Qatar, Oman, Kuwait, the United Arab Emirates, Saudi Arabia, Malaysia, Taiwan and Singapore. The Philippines is also exploring the possibility of signing FTAs with countries outside of ASEAN. It is currently negotiating an FTA deal with Japan. Taiwan also signed its first FTA, with Panama in August 2003, and is exploring similar FTAs with a number of countries.

China has also been very active in pursuing FTAs deals with countries in East Asia. It is now negotiating/studying FTAs with ASEAN and countries such as New Zealand, Australia, Japan and Korea. Japan signed an FTA in January 2002 with Singapore and another in September 2004 with Mexico. Japan is currently conducting official negotiations to conclude FTAs with Korea, Thailand, Malaysia and the Philippines, among which a basic agreement with the Philippines was reached in November 2004. Negotiations with Indonesia and ASEAN as a whole will be initiated in the first half of 2005. Korea also concluded an FTA with Chile in October 2002, for the first time in its history. In addition, Korea started formal government level talks with Japan for an FTA in December 2003, and with Singapore in February 2004. As both China and Japan have begun actively seeking FTAs with ASEAN, Korea also began a joint study with ASEAN in March 2004 for the feasibility of a Korea-ASEAN FTA. Korea has also been conducting a joint feasibility study of FTAs with New Zealand, Thailand, Mexico and a group of European countries (Switzerland, Norway, Iceland, Liechtenstein). Korea has also considered concluding FTAs with Canada, India, New Zealand, Australia, the EU and the US. Multi-country agreements are also being negotiated, proposed or studied in East Asia. ASEAN and CER countries discussed a link between the two free trade areas in November 2000. A Northeast Asian Free Trade Area consisting of China, Japan and Korea is also being studied. At the “ASEAN Plus Three” summit in November 1999, Japan, Korea and China agreed to launch a joint research project involving institutes from the three countries to discuss the possibility of forming an FTA among themselves in Northeast Asia. Since then, the three countries have held a summit every year at the ASEAN+3 meetings and have held regular meetings between their finance ministers.

During the summit of the ASEAN+3 countries in November 2001, China and ASEAN announced that they had decided to create an FTA within ten years. The Philippines has also proposed the East Asian Free Trade Area (EFTA), an area covering the whole of East Asia. At the ASEAN+3 summit in November 2001, Korea also called for the formation of an East Asian economic community equivalent to the EFTA.

Such a development is important given that an export led growth and development strategy provided the platform for the region’s remarkable, and prolonged, period of high and sustained economic growth dating back to the 1960s, and that lies at the core of the East Asian Development Model. Export growth remains a key ingredient for the recovery of the region after the financial and economic crisis of 1997-98. The trend towards this new regionalism, the reasons for it, its impact upon the region, its future evolution and prospects are, therefore, of profound regional, and indeed global, significance.

While the recent regionalism of East Asia is not an altogether “new” idea, as Mahathir Mohamad the former Prime Minister of Malaysia proposed an East Asian Economic Group (EAEG) a decade ago, in practical terms it has only progressed rapidly more recently. Progress, however, has been proceeding more rapidly on financial issues than on trade, and there has been much discussion about creating an Asian Monetary Fund (AMF) and common currency baskets. Hong Kong and the Philippines have proposed the creation of the Asian Currency Unit (ACU). An Asian Bank for Reconstruction and Development and an Asian BIS (Bank for International Settlement) have also been discussed. A more concrete example of achievement in this area, however, is the Chiang Mai Initiative.

The important question is why have the East Asian countries changed their course of direction towards pursuing preferential arrangements? There are four main factors relating to the world economy that are relevant to this issue. The first factor is the slow process of liberalization under the WTO. Specifically, the failure of the WTO to begin a new round of multilateral negotiations in Seattle in 1999 as well as the more recent failure to make progress in Mexico in 2003, illustrate the difficulty of pushing through comprehensive multilateral liberalization. A second factor is the enlargements of the EU and growing Pan-American moves to increase free trade arrangements, such as expanding the North American Free Trade Agreement (NAFTA) into the proposed Free Trade Area of the Americas (FTAA) that includes the entire American continent except Cuba. Thus the EU process of economic integration has resulted in the proliferation of RTAs in the rest of the world.

The third factor is the East Asian financial crisis of 1997-98, which demonstrated the risk of contagion and investors' perception of the region as a “single market”. This factor may have operated as a trigger, which explains the timing of the recent movement towards regionalism in East Asia, given the underlying changes outlined in the first two factors. In addition, cooperation among the East Asian countries during the crisis (such as in the provision of stand-by credit, the Miyazawa Fund, and China’s devaluation policy) nurtured mutual trust and the concept of “East Asia” as a natural entity heading for integration. The impotence of the Asia Pacific Economic Cooperation Forum (APEC) and ASEAN in the wake of the financial crisis also added to the urgency to consider alternative means to ensure the stability of future trading and financial arrangements in the region.

Finally, there is the de facto integration of the East Asian economy, symbolized by active cross-border production sharing. Hence, despite a complex historical/cultural background, people in East Asia are now
increasingly sharing the view that East Asia is a natural economic entity heading for closer economic integration.

The region is currently standing at an important crossroads in terms of its economic development and growth, and a book such as this, with its focus on such a key contemporary issue for East Asia in the form of closer trade and monetary arrangements, is particularly opportune. The need to provide such an analysis, and discussion, stimulated the interest of the editors to produce this book. In addition, the participation of leading researchers on Asian trade and monetary cooperation in this project also provided a further major stimulus.

1.2 BOOK OUTLINE

The book consists, after an Introduction, of four parts: Background and Context; Issues in Trade and Investment Cooperation in East Asia; Country perspectives on Asian regionalism; and Monetary cooperation in East Asia.

Background and Context

This section of the book provides an overview of the expanding trade integration, and its various forms, and production networks among the economies of East Asia, that provide the basis for the increasing interest in, and logical expansion of, the further economic integration of the East Asian economies.

In Chapter 2 Robert Scollay conducts an extensive overview and stock-take of the evolution of preferential trading arrangements in East Asia and the Asia-Pacific region more generally. He provides a review and summary of the existing system and how it has evolved to this point in time, and the key factors that have contributed towards the movement to preferential trade agreements and away from further trade liberalization based on the WTOs principle of a non-discriminatory and fully consistent multilateral approach to trade liberalization. The author argues that recent changes in attitudes towards preferential trade agreements by Japan and Korea, in particular, marked a watershed for the East Asian region as a whole. An extensive review of the smorgasbord of trade agreements currently in effect, under consideration, or soon to become effective is presented.

The chapter also presents the results of simulations of a number of proposed Asia-Pacific preferential trade agreements (PTAs) using a modified version of the standard GTAP (Global Trade Analysis Project) model, to compare the potential relative welfare effects of different possible PTA configurations. The key implication from this exercise, not surprisingly, is that larger and more inclusive trade blocs produce more favourable outcomes for their members than smaller more limited arrangements. The larger the group the greater the potential for trade creation and reduced risk of trade diversion. Thus, an East Asian trade bloc is likely to yield more favourable welfare outcomes for the majority of its members than the more limited arrangements involving subsets of these economies. In turn, for APEC members as a group as well as for most individual APEC members, the prospective welfare outcomes from the implementation of one or other of the possible modes of APEC-wide liberalization are superior to those from an East Asian trading bloc, in some cases by a considerable margin. Hence, the author concludes, multilateral liberalization on a non-discriminatory basis will produce superior welfare outcomes to those from any regional initiative, including APEC. However, the reality is that this is not the direction along which the governments of the region are moving. The dominant trends are towards the continuing proliferation of bilateral agreements and the development of so-called “hub and spoke” configurations. The author then conducts a discussion of the implications of these results and then presents some observations on issues relating to the future evolution of PTAs involving East Asian economies.

In Chapter 3 David Roland-Holst presents a structural analysis of global supply networks and multilateral trade linkages in the context of the East Asian region. He argues that the movement towards a more open multilateral trading system resulted in a proliferation of supply chains in the region, with the role of private capital flows in the form of FDI being pivotal in this process as well as influencing patterns of regional production and trade. An important implication of the resulting supply chain decomposition is that the global network of value creation and income linkages is much more extensive and complex than would be suggested by bilateral trade statistics alone. The author argues for this reason that the significance of existing multilateral ties, as well as the gains from a more liberal trading environment, may be seriously underestimated.

To assess the significance of such global networks, and supply chain decomposition generally, the author compiles an international Social Accounting Matrix (SAM) using detailed international bilateral trade data. This international SAM is then used to conduct a multiplier decomposition analysis. The results obtained indicate that these network effects are complex, largely mediated by intermediate supply and intra-industry trade, and often represent the majority of value creation. They reach across geographic boundaries and sectors in ways that are impossible for policy makers or trade negotiators to anticipate by intuition alone. Open multilateralism, is therefore, a pervasive phenomenon that the conventional view of gains from trade seriously understates.

Issues in Trade and Investment Cooperation in East Asia

This section of the book further elaborates upon issues relating to the extent, nature, significance and performance of key trade and investment linkages
among the economies of East Asia—production networks, trade relationships and their significance, and factors affecting FDI utilization and competitiveness.

In Chapter 4 Fukunari Kimura and Mitsuyo Ando further analyse the importance of international production and distribution networks in East Asia, but this time within the context of the prospective formation and establishment of regional free trade agreements. It reviews the nature and characteristics of international production/distribution networks in East Asia, discusses in detail the role of FTAs in rationalizing import-substituting industries, and proposes new elements of FTAs that will further activate international production/distribution networks. The authors argue that one of the reasons for the increasing interest in the region for further integration and the formation of free trade agreements bilaterally and for the region as a whole, has arisen from the formation of international production/distribution networks during the past decade. They also argue that there has been an important qualitative change in the East Asian economy during the last decade, with FDI playing a pivotal role in this process. Changes in FDI hosting policies contributed to an unprecedented formation of international production/distribution networks in East Asia along the lines of fragmentation theory. They further argue that regional FTAs should be designed in such a way as to be consistent with these new characteristics of the East Asian economy, enabling further facilitation of these international production/distribution networks. These networks will require new policy packages that recognize their breadth and complexity within the scheme of FTAs. If a region-wide integration is the aim then the contents of such an FTA must be designed with this in mind.

In Chapter 5 Ryuhei Wakasugi and Kazuhiko Itoh analyse the effect of regional trade agreements on non-member country exports and production. Specifically, they empirically examine how the bilateral trade flow and foreign production of a non RTA member country is affected by the establishment of an RTA, and that Japan as an example of a non-member country. Using estimates from a gravity equation they find that the formation of NAFTA and AFTA did not negatively affect Japan's trade with those member countries. They find that the growth in Japanese exports is largely caused by trade expansion between member and non-member countries rather than by trade expansion with member countries. Hence Japan benefited more from worldwide trade expansion than from regional trade expansion within RTA member countries. Similarly, with regard to the production of Japanese affiliates in foreign countries, their estimation results indicate that the formation of NAFTA and AFTA did not negatively affect the foreign production of Japanese firms in their member countries. However, the empirical examination again shows that growth in the foreign production of Japanese affiliates is largely caused by trade expansion between member and non-RTA member countries rather than by

trade expansion within member countries, again suggesting that Japanese foreign production can be attributed mainly to global trade expansion rather than to regional trade expansion within RTA member countries.

These findings, therefore, reveal that the expansion of trade and the foreign production of Japan have been caused by worldwide trade expansion rather than by regional trade expansion, although RTAs did not necessarily affect Japanese trade and production in foreign countries negatively. Thus, global, rather than regional, trade liberalization is indispensable to the growth of Japanese exports to, and production of, Japanese affiliates in RTA member countries. These results suggest that Japanese trade policy should primarily be formulated on the basis of liberalizing the world trade system within the GATT/WTO framework, as well as deepening the regional free trade system through the introduction of RTAs.

In Chapter 6 Komail Tayebi conducts an empirical investigation of the key factors determining export flows amongst some member countries of ASEAN (Singapore, Malaysia, Indonesia, Thailand and the Philippines). The econometric analysis uses the panel data method and relies on some of the main features belonging to gravity models, with the objective of testing the hypothesis of the extent to which trade integration affects the intra-trade flows of ASEAN members and their own volumes of imports and exports. The author also attempts to improve upon the technique by extending the range of topics these models may cover.

The estimation results indicate that trade integration between ASEAN members and their partners would increase the amount of trade flows between them. The larger the number of countries taking part in such an integration the more effective would cooperation be amongst its members. Hence the key implication of the current study is that most nations in the bloc are able to benefit from integrating their economic activities, and also benefit from economies of scale.

In Chapter 7 Yanyun Zhao and Zhao Lei use panel data to conduct a comparative analysis of the key factors influencing the utilization of FDI, and the relative importance of these factors, between the ASEAN+3, ASEAN+1 and EU countries. They attempt to identify common and different factors affecting the utilization of FDI, emphasizing in which aspects the ASEAN+3 countries may be particularly lagging. Since the countries of ASEAN are at various stages of economic development they also conduct an empirical analysis of each ASEAN+3 country for FDI utilization using a Partial Least Squares (PLS) model, with the objective of identifying key differences between them.

Their results suggest that, generally speaking, more factors influence FDI utilization in ASEAN+3 than for the EU. For ASEAN+3 GDP per capita, economic strength and finance, international trade, and a safe social environment and stable political situation are particularly attractive for FDI
utilization. The influential factors on the utilization of FDI for ASEAN+3 are almost the same as those of ASEAN+1, but the exclusion of Japan and Korea noticeably changes the relative importance of some of these variables.

Country Perspectives on Asian Regionalism

This section focuses upon developments in regional economic integration from the perspective of various individual countries and groups of countries.

In Chapter 8 Suthiphand Chirathivat presents an ASEAN perspective on movements towards East Asia-wide regionalism, where the latter is considered to be ASEAN+3. The author suggests that the costs and benefits of reducing trade barriers for regional partners need to be assessed properly. China is shown to be the most heavily protected country compared to ASEAN-6, Korea and Japan, and with trade liberalization it seems likely to gain most in terms of GDP and trade. ASEAN, however, could also make GDP gains, and these are likely to be relatively larger than for Japan and Korea. ASEAN, Japan and Korea are likely to emphasize exporting their products to supply China’s vast market, which could result in slight trade diversion especially with those developed countries outside the region.

The author argues that a more integrated Asia-wide region will multiply the difficulties in terms of current developments and future challenges, however it must be hoped that the current proliferation of bilateral deals in the region will support, and not substitute, efforts towards Asia-wide regionalism. He also argues that the policy framework to assist this initiative must be market-driven and carried out with a view to increasing economic efficiency, better resource allocation, and openness for more competition. On the other hand there is a need to develop in parallel a long-term end goal of an Asia-wide regionalism that fits the present economic development needs of the East Asian economies, and is consistent with their further integration into the global economy.

In Chapter 9 Chan Hyun Sohn and Hyun-Hoon Lee discuss developments in East Asian Regionalism from a Korean perspective. In doing so they review recent movements toward regionalism in East Asia and discuss how Korea, and the other countries of East Asia, have responded to these developments and are likely to respond in the future in both plurilateral and bilateral contexts. The authors also highlight six important selection criteria that could be useful in determining eligible FTA partners for Korea.

Based on the selection criteria the authors suggest that among the various options for plurilateral trade arrangements, three options are plausible for Korea. The first option is that Korea and a subset of countries form a sub-regional agreement within APEC. Specifically, OECD member countries within APEC (such as the US, Japan, Canada, Australia and Korea), and some other advanced open economies (such as Singapore, New Zealand and Chile) could agree on forming an FTA among themselves. The second option is to pursue an ASEAN+5 FTA. A third option is to establish a Northeast Asian Free Trade Area. On the other hand, Japan, China and Singapore could be bilateral FTA partners for Korea, entailing large trade creation effects and lesser degrees of trade-induced adjustment costs. Lastly, the authors argue that it is important for Korea to ensure that any FTA initiatives are consistent with multilateral trade rules.

In Chapter 10 Tang Zongming and Tran Van Hoa provide insights into the implications for China’s economic development arising from the growth of regional trade agreements in East Asia. The chapter analyses the performance and describes the key features of China’s recent rapid economic growth. It then examines the importance of the Chinese economy for the other economies of East Asia, and the potential impact of regional integration, such as ASEAN+3 or its subset ASEAN+China, on China’s economic development.

The authors argue that while China does compete against its neighbouring countries, such as ASEAN and Korea, the negative influence of competition would be offset by the benefits that China offers to these nations as their key trading partner. China’s trade liberalization, as a result of its accession to the WTO and the formation of an ASEAN-China FTA, the authors argue, would provide an important opportunity for expanding current trade and investment activities between the East and South East Asian countries and China. China will continue to provide East and South East Asian nations with considerable opportunities to expand their economic development, due to its low labour costs and a sizable domestic market. According to the authors, future closer economic integration between China and the economies of ASEAN will, therefore, be of considerable mutual benefit.

In Chapter 11 Tran Van Hoa outlines the development of new Asian regionalism and ASEAN+3. He also provides a linkage between ASEAN+3 and gravity theory, and outlines a new approach, the extended gravity theory, used in this study for analysis of the impact of ASEAN+3 on Asia-Australia trade and growth. A simple trade-growth model is also introduced and results from its estimation are reported. An analysis of these empirical findings and implications for policy regarding Asia-Australia trade, growth and economic policy are also presented.

The resulting trade-growth models using an extended gravity theory for ASEAN-Australia, Asia 3-Australia and ASEAN-3-Australia and their empirical findings appear to support the premise that trade does cause growth among the trading partners, but the evidence is weak statistically and in magnitude. More important to growth, however, are the economic, financial and other external or domestic crises, and trade and economic relations policies that promote regional cooperation to avoid, or to manage better, future similar crises. The author argues that trade and economic relations between ASEAN+3 and Australia should be encouraged, because it will strengthen bilateral cooperation and result in mutual benefits.
Monetary Cooperation in East Asia

The final section of the book explores some key issues involved in the process of developing closer monetary integration in East Asia. This is a logical extension to the closer economic and trade integration focused upon in the previous sections. In particular, the issue of the potential advantages and disadvantages of closer monetary integration for country and regional stability, and the possibility of establishing a common currency basket are emphasized.

In Chapter 12 Charles Harvie presents a conceptual framework for analysing the policy coordination benefits and costs for a small country whose macro-economy is strongly influenced by a large country, or bloc of countries. A simple Dornbusch (1976) type model is developed for both the small and large countries. The impact of external shocks emanating from the large country, and their impact upon the small country is then analysed by means of a numerical algorithm. Emphasis is given to their impact upon the small country price level, exchange rate, interest rate and output. Three exogenous shocks emanating from the large country are focused upon - interest rate, output and price level.

In analysing each of these shocks individually, the results tended to suggest that the adoption of an independent policy stance (involving a no policy response) produced more desirable macroeconomic outcomes for the small economy. However, in a simulation scenario involving external shocks arising from all of these variables the results obtained were less clear-cut. Indeed, the author finds that taking these shocks as a group, a coordinated monetary response by the small country could be best. However, if the aim of the small country was upon attaining price and output stability, the no policy response option could still be preferable.

Finally, in Chapter 13, Eiji Ogawa and Kentaro Kawasaki investigate the prospects and key issues involved in creating a common currency basket in East Asia according to optimal currency area theory. In doing so they conduct an empirical analysis of an optimal currency area in East Asia using a Generalized Purchasing Power Parity (G-PPP) model. In particular, they investigate which East Asian countries are conducive to the establishment of a common currency area. The empirical results presented suggest that the ASEAN+5 countries, Korea and China are able to form a common currency area, and that a common currency basket will be more applicable as an anchor currency rather than that of the US dollar. They emphasize that a common currency basket is more applicable as an anchor currency than the US dollar in forming a common currency area in the region. Policy implications arising from these results are also discussed.

The authors argue that it is necessary to create a common currency basket for the East Asian countries in order to resolve a coordination failure in exchange rate policies amongst them. In addition, they also suggest that the

European experience with the European Currency Unit (ECU) could provide useful information in establishing a common currency unit in East Asia. Since the East Asian countries have international trade relationships with Japan, the United States and the European countries, a possible common currency unit in East Asia would consist of the US dollar, the Japanese yen and the euro. This is in contrast to the ECU which only consisted of intra-regional currencies.

The authors also make the important observation that if the monetary authorities of the East Asian countries intend to implement regional policy coordination, as a premise they need to create a common currency area. It is difficult for them to conduct regional policy coordination unless they have common policy objectives. It is essential that they have common objectives in monetary and exchange rate policies, in order to create a common currency area.

NOTES

1 See, for example, Table 9.1, p. 173 below.
2 ASEAN-6 countries consist of Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand.
3 ASEAN-5 countries consist of Indonesia, Malaysia, the Philippines, Singapore and Thailand.

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