Regionalism and East Asian economic integration

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Abstract: The wave of economic globalization moves to all the countries in the world to be integrated with multilateralism and by promotion of the General Agreement on Tariffs and Trade/World Trade Organization (GATT/WTO). Meanwhile, the growth of regional economic integration has been one of the major developments in international economic relations, and undoubtedly regionalism is a part of the global economic environment. The objective of the paper is to review the trends and highlight the prospects for enhancing economic integration in East Asia. This paper has argued that the emerging East Asian economies have achieved sustained economic development and poverty reduction through domestic structural, institutional and governance reforms as well as through market-driven integration with the global and regional markets. Though this process was temporarily interrupted by the Asian financial crisis in 1997-1998, the economies have pursued further liberalization and reforms, deepened economic integration through trade, FDI and finance, and regained dynamic growth. The author argues that the reasonable choice for Eastern Asian countries is to deepen their economic integration and the optimal strategy is fostering economic integration with institutional cooperation.

Key words: East Asia; Economic Integration Area (EIA); regionalism; multilateralism

East Asia has become a distinctive and crucial region of the world now. In the new millennium, the irrevocable trends such as globalization, the information revolution, and growing interdependence among nations will present East Asia with new challenges and opportunities for regional collaboration.

In the past, political rivalries, historical animosities, cultural difference and ideological confrontation posed barriers to cooperation among East Asian nations. Disparities in stages of development, trade and economic policies and financial and legal framework have also impeded closer economic cooperation. In social and cultural fields, significant poverty and illiteracy still plague the lives of millions in the region.

Despite of heterogeneity, East Asian nations share geographical proximity, common historical experiences and similar cultural norms and values. The region has nations that are endowed with abundant skilled labor, entrepreneurs, natural resources, capital and advanced technologies.

Many common challenges and complementary resources call for mutual beneficial cooperation and exchange, not only in economic realm, but also in political, security, environment, social, cultural and educational fields.

Globalization of the world economy, together with the trend towards regional trading blocks, bring new challenges such as the need to define global standards, harmonize regulations, and engage in mutual trade negotiations. These issues call for more deliberate regional cooperation and economic integration.

The East Asian financial crisis in recent years has further provided a strong impetus to strength regional cooperation. This has given rise to the recognition that East Asia needs to institutionalize its cooperation to solve

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similar problems and prevent new ones.

The aims of the paper are to understand the key characteristics of East Asian economies and look into the possibilities and complexities in the paths of economic integration.

1. Regionalism and logic behind regionalism

The growth of regional trading blocs has been one of the major developments in international relations in recent years; virtually all countries are members of at least one bloc. Over a third of world trade takes place within regional integration agreements—nearly two-thirds, if Asia-pacific Economic Cooperation (APEC) is included (Maurice Schiff, L. Allan Winters, 2003).

Regionalism is a part of the global economic environment as well as multilateralism. Regional agreements vary widely, which can usually be divided into five levels: Preferential Trade Arrangement (PTA); Free Trade Area (FTA); Customs Union (CU); Common Market (CM) and Economic and Monetary Union (EMU). For want of a better term, we lump them into the category of regional integration agreements (Rios). From 1948 to April 2002, 194 regional integration agreements had been notified to the General Agreement on Tariffs and Trade /World Trade Organization (GATT/WTO) (Maurice Schiff, L. Allan Winters, 2003). Since the middle of 1990s to 2008, 199 regional integration agreements have been notified to the General Agreement on Tariffs and Trade /World Trade Organization (GATT/WTO).

1.1 Regionalism in history

At perspective of history, Regional Integration Agreements (RIAs) have been around for hundreds of years. For example, a custom union of the provinces of France was proposed in 1664; Austria signed free trade agreements with five of its neighbors during the 18th and 19th centuries; and the colonial empires were based on preferential trade agreements.

Partly in response to the Great Depression of 1930s, and partly under the influence of U.S. idealism and internationalism, the post-world war Ⅱ system established equal treatment of all partners (nondiscrimination) as a fundamental principle of the trading system. Exceptions were permitted, both on pragmatic grounds and for reasons of principle, and among these exceptions was the ability to create trade bloc—Free Trade Areas (Fats) and Customs Unions, which contributed to the political reconstruction of Europe through the creation of the Benelux Customs Union in 1947, the European Coal and Steel Community (ECSC) in 1951, and more far-reaching European Economic Community (EEC) in 1957. In the 1980s, a huge change in attitudes toward international trade and competition took place. Led by the EU’s single market program, a new wave of apparently more liberal RIAs emerged. The recent growth in regionalism was dominated by the EU’s activities: The extension of the single market programme to neighboring countries that were not yet members of the EU, through the European Economic Area; the signing of Europe Agreement with the countries of Eastern Europe; and the development of a more active and formal Mediterranean country. But Europe was not the only continent involved. In the Americas the Canada-U.S. Free Trade Agreement of 1988 was extended to Mexico in 1994 through NAFTA; Common Market of the South was formed in 1991 and the Group of Three (G3) in 1995; and the Andean Pact and the Central American Common Market (CACM) were resurrected in 1991 and 1993, respectively. In 1992 the countries of the Association of Southeast Asian Nations (ASEAN), after 25 years of political cooperation with limited trade cooperation, formed a meaningful FTA, the ASEAN Free Trade Area (AFTA). In West Africa the trade blocs reformed in more liberal and more tightly organized blocs. The common market for Eastern and

Southern Africa (COMESA) replaced a preferential trade agreement (PTA). The Southern African Development Coordination Conference (SADCC) transformed into the Southern African Development Community (SADC), which is a trade and economic cooperation association rather than a defense organization. Undoubtedly, regionalism is part of the global economic environment.

1.2 Why regionalism

At perspective of the comparison between globalism (multilateralism) and regionalism, nearly all countries prefer much more to regionalism. Behind the recent contrast in regionalism, there are many factors:

Firstly, regionalism as trade policy. In the comparison with the multilateralism, forming a regional economic areas almost always increase trade between members. The traditional analysis of trade creation and diversion is based on a view of the world in which inter-country trade is driven entirely by differences in productivity and in factor endowments. But trade can also arise from product differentiation and economies of scale, which reduce costs as production grows. RIAs, by fostering trade between members, can generate such benefits (which increases economies of scale) and a large number of firms (which increases competition). When several national markets are merged, the number of producers in each country may fall, while the number of sellers with reasonable access to leach market rises because producers from partner countries now have access. For instance, if each country in a two-country RIA starts off with three firms, even if each loses one firm to intra-RIA competition, there will still be four (now larger) firms producing and selling throughout the bloc.

Secondly, making the most of regionalism. In some content, regionalism can be regarded as a pale imitation of nondiscriminatory. But why is regionalism so popular under the international economic environment of globalization? The reason is that governments will earn much more benefits from RIA. They may be better able to exploit market power against outsiders by coordinating trade policies. They may place a high value on access to partners' markets and feel that it is better ensured by making access to their own markets conditional on reciprocity. They may prefer preferential to non-preferential access to partners' markets. And they may want to exploit the regional market as a base for protected industrialization.

Thirdly is the regionalism and investment. A prominent objective of many RIAs is to promote investment. The logic is that larger markets, more competition, and improved policy credibility will increase the incentives for investment and so raise incomes.

Fourthly, economic growth and industrial agglomeration. Modern growth theory—the theory of endogenous growth—emphasizes the role of knowledge in fostering productivity and growth. Knowledge can be effectively transferred from one country to another through international contacts and trade. The countries can efficiently increase their access to knowledge and technology through RIAs. The economics of agglomeration (or clustering) arose from attempts to understand the possible effects of enlargement and deepening of the EU (Krugman and Venables, 1990). According to the theory, creating an RIA is likely to affect the incentives for industry to agglomerate. Usually, it will encourage clustering by increasing market size and allowing more effective exploitation of the links between firms. RIAs also frequently cause industry to relocate from one member country to another by the law of comparative advantages.

Fifthly, integration of domestic policies. Policy integration—inter-governmental cooperation in designing and applying domestic on taxes, health and safety regulations, the environment, standards and so on—can increase competition in domestic markets by reducing transactions costs and allowing new suppliers to enter markets. Cooperation on domestic policies can also assist in overcoming market failures and can help ensure that trade restrictions are not re-imposed through the back door. Even if the WTO and other multilateral institutions can play a role in policy integration, the performance of them seems to be undesirable due to a very broad WTO agenda.

2. Logic behind and efforts toward East Asian integration

2.1 Logic behind East Asian integration

Around the world, regionalization is gaining ground following the historic introduction of the Euro. Gripped by this wave of regionalism, the debate on East Asian economic integration has intensified. What is the logic behind various initiatives for institutional cooperation to support economic integration?

At first, the most fundamental reason for the emergence of recent initiatives for institutional cooperation to support economic integration in 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 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 2006. 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 like 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 ASEAN excluding Singapore is estimated to be 24 percent and their share in China is 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 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 harmoniz 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 requires institutional cooperation to manage such links and interdependence.

Secondly, 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 Asia. This might put Asia in a disadvantageous position in global competition and multilateral negotiations. 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 loss of steam of the APEC process, this issue has become particularly urgent in trade policies. Governments and business people in 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, the 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.

Thirdly, the Asian financial crisis of 1997-1998 and the recent external shocks to Asian financial markets have 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 which take time to bear fruit. Hence, the general sentiment in 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 the 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, Asian regional financial cooperation contributes to the stability of global finance.

2.2 Efforts towards integration

On East Asian 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 in 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 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.

The next stage is to create an Asia wide FTA, including ASEAN+3 i.e., ASEAN members, China, Japan and Korea and such countries as Australia and India, 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.

3. Pillars and challenges ahead of East Asian integration

3.1 Pillars of East Asian integration

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.

At 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 more effective and disciplined.

Secondly, 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-tem 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.

Thirdly, 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 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 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, 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. The 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. 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, and containment of infectious diseases and adoption of collective response to Tsunami. One of 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”.

3.2 Challenges ahead

There is no doubt that East Asian economies with their strong export orientation, solid base of human capital, and several decades of extraordinary growth behind them, can be expected to thrive in a politically and economically well-integrated environment, especially if this environment helps the region to align well to globalized markets and internationally accepted standards. Weak institutions in East Asia have held back the pace of progress, especially in financial integration. We can expect that East Asian economies will face several challenges as the integration process further evolves and matures. The first of the challenges is the political dynamics. The political dynamics and rationale for integration differ substantially from Europe. After World War II European motivation for regional cooperation was driven by the desire to foster political and social cohesion. Building political and economic interdependence within the EU was seen as a way to address security conflicts in the region. In contrast, East Asia lacks a common vision and mandate for regional cooperation. Some countries are still struggling with political stability, retain historical grudges and sensitivities, and have serious poverty concerns. Different attentions of East Asian countries diversify their political aims which lead to be the lack of a common political vision.

The second of the challenges is the regional role of main economic entities. Since the end of World War II, East Asia has experienced a relatively long period of peace, which provided some spaces for economic prosperity. Historically, all countries have had divergent interests and position on economic matters. They tried best to promote their domestic economic growth by the advantage of globalization. Until now, a common political and economic agenda has not yet defined among the main economic heavyweights, including China, Korea and Japan.

The third of the challenges is lack of an institutional framework for regional integration. The only formal institutional mechanism at the regional level, ASEAN, is a sub regional initiative that lacks members of key East Asian nations and has a voluntary approach to policy implementation. This has at times undermined its effectiveness as a regional institution. With the inclusion of the larger players, ASEAN+3 now operates as a loose alliance that is deliberating on all key issues of financial architecture and coordinating activities related to regional surveillance and exchange of key vulnerability data. Concrete outcomes of these working groups have included the Chang Mai Initiative that led to establishment of swap arrangement among a number of countries. These efforts under ASEAN+3 require coordination to develop a regional financial integration blue print. As for enhancing and expanding free trade and factor mobility. Currently, the only regional free trade and investment agreement, supported by ASEAN, has yielded limited results. While average tariffs may be lower in the region, there continues to be protected in selected sectors and unnecessary barriers to trade, capital and labor mobility. As a result of delays in the latest WTO negotiations, East Asia has now resorted to a multitude of bilateral trade and investment arrangements. For example, despite its strong preference for multilateral trade liberalization, Japan entered into a partnership agreement in 2002 with Singapore. In addition, China and Japan are working on a free trade agreement with ASEAN that will take them beyond WTO agreements and open up more sectors of the economy. These arrangements are a good start on the dialogue, but their consistency with WTO guidelines and consistency among them is critical for an eventual formation of an East Asia Community.

4. Conclusion

Facing the slow progress of the WTO/Doha liberation process and the perceived loss of steam of the APEC progress, East Asian Economic Integration has become a particularly urgent issue. In fact, Market-driven East Asian economic integration has been really developed, but compared to that of Europe and North America, 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 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”. Otherwise, due to the differences in political and economic systems, the pace of institutional cooperation for Asian economic integration may be slow and the multi-speed approach may be needed. Its structure ought to be flexible and open until a stronger political and economic convergence is achieved.

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