Remarks on "Asian Regional Economy in a Multilateral Setting"

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1. Introduction

The East Asian regional economy is finally coming into its own. It is now not merely a source of supply of goods to the rest of the world, but also a large and growing market in its own right. Moreover, trade flows, if not investment flows, within the region have almost surpassed flows outside the region. And despite the East Asian currency crisis of 1997-1998, real economic growth in the region, with the notable exceptions of Japan, Hong Kong and the Philippines, has almost recovered to pre-Crisis levels.

Facilitating the emergence of the East Asian regional economy are two long-term worldwide economic trends: (1) the "de-verticalization" or "fragmentation" of production and (2) globalization of economic activities. De-verticalization and globalization are both in turn greatly aided by the "information and communication technology (ICT) revolution."

"De-verticalization" or "fragmentation" means the vertical division of labor—the physical and often geographical separation (with or without out-sourcing) of design, manufacturing, marketing, inventory, transportation and distribution functions of a firm both within and across national boundaries. De-verticalization enables many more (intermediate) goods and services to be tradable and traded. The concept of de-verticalization is NOT new. For example, in the construction industry, all the "trades" (services) are traditionally performed by specialist subcontractors. Other examples include "original equipment manufacturing (OEM)" in developing economies, the semiconductor industry--"fabless" semiconductor companies and foundries, and overseas "call centers". What is new is that the transactions costs (including monitoring and quality assurance costs) have come way down and that one can "de-verticalize" globally rather than just locally, thanks to the ICT revolution.

The rising globalization of economic activities is made possible by falling barriers (tariff and non-tariff--legal, technical, and institutional) to movements of goods, services and factors, particularly capital, including human capital (witness the WTO, European Union, NAFTA, ASEAN Free Trade Area, and other free trade agreements) and declining costs of communication, transportation and transactions in general.

Moreover, de-verticalization and globalization are complementary to each other. While de-verticalization encourages specialization in tasks rather than products by firms—finding a niche in the global supply chain that maximizes value-added based on "core competence"--these higher-value-added parts of the supply chain face much less competition (Intel, Microsoft, TSMC) and enable the realization of economies of scale and learning by doing effects. It is much more efficient and profitable for firms to expand

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horizontally (to supply multiple customers around the globe) than to integrate vertically. The end result is a renewed impetus for the growth of world trade, especially intra-firm and intra-industry trade, and an expansion of the potential global output. The East Asian regional economy is a major beneficiary of these two worldwide trends.

2. The Emergence of an East Asian Economic Region

The East Asian economic region is taken to be the ASEAN countries (Association of Southeast Asian Nations--Brunei, Indonesia, Khmer Republic, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam) + 3 (China--including Hong Kong, Macau and Taiwan, Japan, and Korea). In 1960, the GDP of ASEAN + 3 was approximately 40% of U.S. GDP, with Japan contributing more than 80% of the total, followed by China (Mainland only), with not quite 8%. In 2000, the GDP of ASEAN + 3 was approximately 75% of US GDP, with Japan contributing more than 60% of the total, followed by China (Mainland only), which contributed somewhat more than 15%. South Korea, and Hong Kong, Macau and Taiwan combined, each contributed between 5% and 10%. Thus, ASEAN + 3 is also comparable to the Zone Euro in terms of the order of magnitude of its GDP. The GDP of Japan is larger than the GDP of all of the other East Asian economies combined. Japan also leads in GDP per capita among East Asian economies, with almost US$50,000 in 2000 (at market exchange rates), followed by Singapore at US$30,000. In contrast, Mainland China's GDP per capita was less than US$900 in 2000. These figures and percentages are sensitive to the exchange rates used for the conversion, but the general conclusions that (1) The contribution of the rest of East Asia to total GDP has increased significantly and (2) Japan remains the leading economy within East Asia in both aggregate and per capita terms are inescapable.

Japan achieved an average annual rate of growth of real GDP in excess of 10 percent during the decade of 1960-1970 (in fact, between 1955 and 1975). However, due to the two oil shocks, the average annual rates of growth in the two subsequent decades declined significantly to less than 5%. And since 1990 the average annual rate of growth has been below 2%. The rest of East Asia, with the exceptions of Brunei, Macau, Myanmar and the Philippines, has been able to grow significantly faster than Japan in the decades of the 1980s and 1990s. In particular, China was able to achieve an average annual rate of growth of almost 10% over the past two decades, a performance comparable to that of Japan between 1955 and 1975. Notwithstanding the East Asian currency crisis of 1997-1998, the other East Asian economies, with the aforementioned exceptions, still achieved respectable average annual rates of growth ranging between 4% and 8% in the decade of the 1990s.

Over the past two decades, intra-East Asian interdependence in terms of trade and capital flows has also risen. The shares of exports of East Asian economies destined for other East Asian economies have been increasing rapidly. The share of Japanese exports for East Asian rose to 40% in 2001. Similarly the share of East Asian exports in Japanese imports also rose to 40% in 2001. By the late 1990s, approximately 50% of the exports of the East Asian economies are destined for other East Asian economies. The increasing shares are a manifestation of the increasing economic interdependence and integration and the emergence of a regional economy.

With the possibility of synchronous economic cycles as, for example, during the East Asian currency crisis of 1997-1998, East Asian economies may experience simultaneous downturns in economic activities, which in turn may cause significant reductions in the demands for one another's exports, further exacerbating their recessions. However, it is also possible that the economic recoveries may be accelerated by simultaneous upturns, with the rising import demands of each economy feeding into rising export demands of its trading partners, as actually occurred during the East Asian currency crisis.

The emergence of the Chinese economy on the global market was the one important new development during the past two decades. China-Japan trade reached US$101.91 billion in 2002 (exports of US$48.44 billion and imports of US$53.47 billion). Japan has been China's largest trading partner for ten years and China became Japan's largest source of imports in 2002. Over time, China has become increasingly an important destination for the exports of other East Asian economies; however, Japan remains more important than China for most of the East Asian economies (in terms of their export ranks), with the notable exception of South Korea—China has supplanted Japan as the second most important export destination for South Korea (the U.S. remains the most important destination for South Korea). In 2001, the shares of imports from East Asian economies were 40% for Japan and 48% for China. These shares have risen for all other East Asian economies (Hong Kong, Taiwan, South Korea and the ASEAN). The ranks of East Asian economies in both China and Japan have also been rising (that is, becoming higher in rank and lower in number) over time. In contrast, the shares of U.S. exports destined to East Asian economies and U.S. imports originated from East Asian economies have declined slightly during the last decade.

Intra-East Asian capital (especially direct investment) flows and technology transfers have continued to rise. Japan, Hong Kong, Singapore, South Korea and Taiwan have become major direct investors in the East Asian developing economies. More recently, Chinese enterprises have also begun to make direct investments abroad.

3. The Prospects of an East Asian Free Trade Area

Economic Complementarity or Competition

Within East Asia, there exists significant economic complementarity between the developed economies (principally Japan) and the developing economies (China and the ASEAN without Singapore)—there is very little overlap and hence competition between what Japan exports on the one hand and China and the ASEAN without Singapore export on the other hand. Japan is still the premiere source of capital goods and technology within East Asia. This complementarity is borne out by the trade statistics at the disaggregated commodity level. The Newly Industrialized Economies (NIEs) of Hong Kong, South Korea, Singapore and Taiwan are actually competitive with the developed economy, Japan, on their high-end goods and with the developing economies on their low-end goods (and with one another). Moreover, the bulk of the Japanese exports as well as exports from the East Asian NIEs consists of intra-industry and intra-firm trade, which indicates that the exports are mostly based on long-term supplier-user relationships and/or direct investment by Japanese (and other) parent firms. Globalization of supply chains and the concomitant de-verticalization of production and outsourcing have accounted for much of the expansion of world trade. Because of the economic complementarity, the free trade area (FTA) with the largest potential gains is therefore a (China-Japan-ASEAN) free trade area. The continued economic development and growth of East Asian economies, including China, therefore present enormous economic opportunities for Japan's capital and technology goods industries.

The Prospects of an ASEAN + 3 (China, Japan, Korea) Free Trade Area

Free trade areas and agreements that have been organized or concluded in East Asia include (1) The ASEAN Free Trade Area (AFTA); (2) The China-ASEAN Free Trade Area; and (3) Japan-Singapore Free Trade Agreement. The most interesting and potentially the most significant FTA is of course the ASEAN + 3 FTA. This may be viewed as a voluntary and co-operative version of the "Great East Asia Co-Prosperity Sphere." A viable East Asian Free Trade Area/Economic Community requires the participation of both China and Japan. (Remember that the potential gains are maximized when the comparative advantages are the most different.) In the ASEAN + 3 FTA, Japan is initially likely to specialize in capital goods

production, complex manufacturing, industrial R&D and quality assurance. The NIEs are initially likely to specialize in the manufacture of heavy industrial and high-technology goods, the provision of financial and other services, and the development of new products. China and the ASEAN without Singapore are initially likely to specialize in the mass manufacture of light industrial goods and processing and assembly and for the ASEAN the provision of primary raw materials as well.

If this FTA ever materializes, it will be through a gradual and painstaking process. It will require a separation between economics and politics, at least initially, in the participating countries; it will have to provide for dual leadership, by both China and Japan; and it will also have to be inclusive. In addition, it will probably need to provide explicitly for a mechanism for publicly funded compensation and re-training of the displaced workers in the participating countries. In principle, the gains from free trade should outweigh the losses. An adequate mechanism for compensating the potential losers is the key to public acceptance and support.

4. International Exchange Rate Coordination and Cooperation

The exchange rate movements among the major currencies (the U.S. Dollar, the Euro and the Japanese Yen) today are caused mostly by capital flows, particularly short-term capital flows, rather than by trade flows or by relative price movements. There are large and persistent discrepancies between market exchange rates and the "Purchasing Power Parity (PPP)" exchange rates.

Co-Ordination and Stabilization of Intra-East Asian Exchange Rates

Predictability and stability of the real relative exchange rates over the medium to long term facilitate international specialization and division of labor (including de-verticalization and global relocation and out-sourcing), cross-border direct investment, and economic growth. It is therefore important to maintain relatively stable real exchange rate parities among the East Asian economies, particularly the developing ones. "Beggar thy neighbor" type competitive devaluation can lead to great instability, both for the individual countries and for the region as a whole (as well as globally). Exchange rate policy coordination among East Asian economies can prevent contagion that may result from unexpected and unintended large changes in the relative exchange rate alignments. Timely intervention can make a significant difference for all—it can prevent over-shooting adjustments with their irreversible negative effects and arrest a possible vicious cycle of competitive devaluation. Moreover, empirically, reductions in exchange risks promote cross-border trade and direct investment just as much as if not more than reductions in tariff and non-tariff trade barriers.

Even in the absence of significant direct trade between two countries, it may still be advantageous for them to maintain a relatively fixed exchange rate parity between them if they compete in the same export markets. The rationale for a fixed relative parity is the same as that for price fixing between two competitors. It maintains the terms of trade of both countries, prevents ruinous competition, and, in particular, can prevent the outbreak of intentional competitive devaluation. This is because exchange rate reaction functions are asymmetric. If a country devalues its currency, it can expect its competitors to match its devaluation, thus negating any pricing advantage for its exports. If a country revalues its currency, it can expect its competitors not to match its revaluation, and hence it is likely to lose competitiveness and market share to its competitors. (In other words, it faces a "kinked demand curve".) Consequently, very few countries are willing to revalue, unless they can be assured that their competitors will match its revaluation so that it is not likely to lose market share. Thus, exchange rates are likely to be "sticky"—there is everything to lose with a revaluation and nothing to gain with a devaluation—and moreover is probably more "sticky" upwards than downwards. And that is why a fixed relative parity agreement may actually help to make the exchange rates

among blocs of currencies more flexible, since the aversion of each individual country to a revaluation is significantly reduced.

The East Asian economies fall into two distinct groups—the industrialized and newly industrialized economies of Japan, Republic of Korea, Taiwan, Singapore and Hong Kong—and the developing economies of China, Indonesia, Khmer Republic, Malaysia, Laos, Myanmar, Philippines, Thailand, and Vietnam. Moreover, the economies in the two groups compete in their exports only with economies within the same group (Singapore and Hong Kong, being city-states, are actually not major exporting economies in any case), and not with the economies in the other group. Thus, it makes sense for the economies of each group to maintain relative real exchange rate parities among themselves. If the relative real parities are relatively fixed, the exchange rates of the entire bloc vis-à-vis the major currencies of the U.S. Dollar and the Euro can more readily adjust in response to any significant changes in the relative fundamentals between the East Asian economies and the U.S. or the European Union. To the extent that there is significant intra-firm and intra-industry trade between the two groups of economies, it also makes sense for the two groups of economies to maintain a stable relative real exchange rate parity between them.

Mechanisms for Exchange Rate Policy Coordination

Exchange rate policy coordination can take many forms. Currently there already exists a multilateral currency swap framework with bilateral agreements among the ASEAN + 3 economies. They have approved, in principle, bilateral standby swap arrangements for the support of the exchange rates of individual economies. It is also possible to have multilateral or bilateral agreements on settlement of transactions in the currencies of the countries instead of the U.S. Dollar (up to a maximum amount if necessary), thus conserving foreign exchange reserves and freeing them up for potential use in emergencies. An East Asian Currency Stabilization Fund that can act as a lender of last resort can also have a useful role to play by augmenting the potential foreign exchange reserves perceived to be available for the defense of any single currency. The mere existence of such a region-wide currency stabilization facility can actually discourage speculation and help stabilize the exchange rates of smaller East Asian economies.

To the extent that a system of stable relative exchange rate parities can be maintained in East Asia, it can become the beginning of an East Asian currency "snake". It will likely start with the East Asian developing economies (including Cambodia, China, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand and Vietnam) maintaining stable relative parities with one another. The industrialized and newly industrialized economies of Japan, South Korea and Taiwan can also maintain stable relative parities among themselves (Hong Kong is pegged to the U.S. Dollar and Singapore is pegged to a basket of currencies).[1]

The emergence of an East Asian currency can be accelerated if there is, over time, a change in the currencies used for invoicing and settlement in intra-East Asian trade. This can begin with the East Asian economies accepting other (possibly non-convertible) currencies for settlement of their exports. In the interim, the economies accepting these currencies can be granted options to redeem the currencies for gold at a pre-agreed fixed parity (An East Asian "Gold Standard"). Moreover, one or more countries may provide the liquidity for the others (and earn the seigniorage). Other countries may be able to acquire the currency(ies) by running export surpluses vis-à-vis the country(ies) providing the currency(ies) and accepting the currency(ies) as payments in return. In time, substitute currency(ies) for the U.S. Dollar will emerge.

5. An East Asian Free Trade Area/Economic Community?

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[1] However, the volatility of the Yen/US$ exchange rate must be significantly reduced in order for an East Asian snake or more permanent arrangement to be viable.

An East Asian Free Trade Area/Economic Community will take decades to get off the ground. The evolution of the European Union provides an historical precedent—it has been a more than 50-year process, beginning with the Bank for International Settlements and proceeding progressively to the European Coal and Steel Community, the European Common Market, the European Economic Community, and now the European Union and the Zone Euro. The successful formation of the European Union was due in no small part to the wisdom and far-sightedness of statesmen in both France and West Germany. The support of the United States and the pressure of the Soviet threat also helped to overcome internal political differences.

The question for East Asian countries is whether there exists the political will to move towards an East Asian Free Trade Area/Economic Community. Is each of the East Asian economies ready to trade increased exports for increased imports, thus realizing the gains from specialization and economies of scale? Are the East Asian economies as a group ready to restrain nationalistic sentiments and support the rise of global companies by facilitating the free movement of long-term capital and direct investment? Can China, Japan, and the other East Asian countries put their historical enmity behind them and enter a new era of mutual cooperation and benefit? Japan can play a leading role in the economic future of East Asia. An East Asian Free Trade Area/Economic Community may even be a stimulus for renewed economic growth in Japan. The choice for Japan is whether it wants to be East Asia's West Germany or East Asia's United Kingdom.