

Regional Economic Integration in East Asia and Japan

Shujiro URATA

Waseda University

I. Introduction

East Asia achieved rapid economic growth for the last several decades, although there are variations among them in terms of the rate of economic growth. For example, compared to developing countries, Japan, which achieved high level of economic development, registered low economic growth. By contrast, China achieved extremely high growth in recent decades. A number of factors such as high savings and investment, and availability of low wage labor, have contributed to rapid economic growth of East Asia's developing countries. Among these factors, rapid expansion of foreign trade and foreign direct investment (FDI) has played very important roles, as they led to the formation of regional production network in East Asia, which has become an engine of economic growth in East Asia.

With this background information in mind, I would like to discuss international economic situations in East Asia by examining changing patterns of foreign trade and investment. More specifically, I will focus on regional economic integration in East Asia in recent years. After making observations on the nature of regional economic integration in East Asia, I will discuss the major drivers behind such development. In the discussions, I would like to argue that the major driver of regional economic integration in East Asia is changing from market forces to institutional factors. In the discussions, I would like to shed light on the role of Japan in these developments. Most of my discussions refer to the developments before the current global economic crisis

because of the data availability, but I would like to discuss briefly its impacts on East Asia and the implications for the future economic prospects of East Asia.

II. Market-driven Regional Economic Integration

Several notable developments can be observed regarding foreign trade and investment in East Asia. Let me discuss the changing patterns of foreign trade first and then turn to foreign direct investment.

Several notable developments can be observed for foreign trade in East Asia. First, as can be seen from Figure 1, East Asia's exports and imports increased rapidly approximately 10 fold in 26 years from 1980 to 2006. As the rate of increase of foreign trade by East Asian countries exceeded that of world trade, the share of East Asian in global trade increased notably. Although East Asia's foreign trade as a whole increase notably, wide variations can be found for international trade among East Asian countries. Specifically, China's trade expanded most rapidly while Japan's trade did not increase as rapidly. As the result of the differences in trade performance by different East Asian countries, the composition of country shares among East Asian countries changed. As can be seen from Figure 2, in terms of exports China's share increased notably from the 1990s to 2006, while Japan's share declined during the same period.

Second, regional economic integration has been advancing notably in East Asia. This can be seen from the increase in the share of intra-regional trade in region's overall trade, or the intra-regional trade ratio, for East Asia. As shown in Table 1 for East Asia, the intra-regional trade ratio increased from 35.5 percent in 1980 to 52.3 percent in 2007. The corresponding increases are smaller for the NAFTA and the EU. Having noted increases in intraregional dependence in East Asia, one observes substantial differences in the degree of intraregional dependence among the East Asian countries. Similar to the

finding of the increasing importance of China in East Asia's foreign trade, the importance of China as an export destination as well as an import source for other East Asian countries. As can be seen from Figure 3, the importance of China as an export destination for Japan, the NIEs, and ASEAN countries increased notably in recent years, while as shown in Figure 4 the importance of Japan declined for China, the NIEs, and ASEAN countries. What is to be noted is the declining importance of other East Asian countries as export destinations for China, while their importance as import sources for China increased.

Third, the product composition of foreign trade of East Asian countries changed, as the share of manufactured goods, particularly machinery such as electronic machinery, increased notably. As can be seen from Table 2, the share of electric machinery in total exports and imports for East Asian countries increased from 16.2 and 14 percent in 1990 to 23.3 and 24.9 percent in 2005, respectively. It is interesting to observe that the composition of foreign trade among East Asian countries have become similar.

Fourth, continuing on the discussions on changing product composition of foreign trade, we find that foreign trade in parts and components increased enormously in East Asia. The importance of parts and components in foreign trade is larger for intraregional trade in East Asia when compared to their trade with the rest of the world.

I have discussed four notable developments regarding foreign trade in East Asia. They are rapid expansion in foreign trade, increase in intraregional trade, increase in electronics trade and increase in parts and components trade, especially in the case of intra-regional trade. Those findings indicate the formation of regional production networks in electronics industry in East Asia, under which parts and components are traded and finished products are assembled in East Asia. The development of regional

production networks result from the fragmentation strategy of multinational corporations, under which a production process is divided into sub-processes and these sub-processes are located in a country where the sub-processes can be conducted at the lowest cost. Although not shown clearly in the figures and tables we saw, a closer look at the pattern of foreign trade in East Asia show the triangular pattern in that parts and components of electronics products are shipped from Japan, the NIEs, and ASEAN to China, where final products are assembled with those parts and components, and then these final products are exported to the US and the EU for final consumption. As a result of these developments, China became to be a factory for the world market. Since the fragmentation strategy, which led to the formation of regional production networks, has been carried out through foreign direct investment by multinational corporations, we turn to the recent development in foreign direct investment in East Asia.

Turning to FDI flows in East Asia, one finds that both FDI outflows and inflows increased more or less steadily from the 1980s through 2007 (Figure 7). However, unlike the case for foreign trade, East Asia's share in world FDI did not rise because FDI between and among Europe and the US increase enormously over time. Several important developments can be observed regarding FDI inflows in East Asia, which contributed to the formation of regional production networks. First, as can be seen in Figure 8, similar to the case for foreign trade, China has become a very large recipient of foreign direct investment inflows. By contrast, FDI inflows to Japan are very limited. Second, intra-regional dependence in FDI inflows increased but its level is not as high compared to the case for foreign trade. As shown in Table 4, the intraregional FDI inflow ratio increased from 19.5 percent in 1997-2001 to 24.6 percent in 2002-2006, but the level in 2002-2006 is significantly lower compared to over 50 percent for the case of foreign trade. Third, similar to the case for foreign trade, FDI

inflows to electronics sector increased sharply, resulting in the increase in its share in FDI inflows to the manufacturing sector (Table 5).

Limited availability of data on foreign trade by multinational corporations and their overseas affiliates precludes us from conducting an analysis of relationship between foreign trade and foreign direct investment. However, analyses of data covering Japanese and US multinational corporations, for which some data are available, reveal the development of triangular trade in electronics industry. Indeed, the development of triangular trade resulting from the development of regional production network has been shown to have contributed to rapid economic growth in East Asia.

III. Trade and FDI Liberalization in East Asia

Several factors have contributed to rapid expansion of foreign trade and foreign direct investment in East Asia. Technical progress in information and communication technology and transport technology lowered the cost of communication and distribution, enabling the companies to expand trade and investment. Changes in policies including deregulation, trade and FDI liberalization policies had significant impacts on the expansion of trade and FDI. Let us examine trade liberalization by East Asian countries, for which data are available.

As can be seen from Figure 9, the average tariff rates for East Asian countries declined significantly since the 1980s. Many East Asian developing countries embarked on unilateral liberalisation of trade and FDI policies and deregulation in domestic economic activities as part of more comprehensive structural reform policies. Such policy changes were induced partly by their commitments to the World Bank and the IMF for obtaining economic assistance and largely by the realisation by the East Asian countries that these changes would promote economic growth. It is important to note

that the GATT/WTO contributed to trade liberalization in East Asian countries. A case in point is trade liberalization in China, as China had to liberalize its trade regime in order to join the WTO. APEC also contributed to trade and FDI liberalization in APEC member economies although trade and FDI liberalization was based on voluntary basis. In addition to these global and regional frameworks, bilateral and plurilateral frameworks have contributed to trade and FDI liberalization in recent years, which will be discussed in the next section.

We found that trade and FDI liberalization contributed to rapid and large expansion of trade and FDI, which resulted in regional economic integration in East Asia. Because it is the activation of market forces resulting from trade and FDI liberalization that promoted regionalization in East Asia, such regionalization is characterized as market-driven regionalization.

Having argued that East Asian countries pursued trade and FDI liberalization since the 1980s, we have to point out that for many countries there still exist a lot of room for liberalization in both trade and FDI regimes. Table 6 shows the existence of relatively high tariffs, particularly in agricultural products, in East Asia, while Table 7 indicates various impediments to foreign direct investment including lack of transparency in policies and regulations concerning investment, complicated and/or delayed procedures with respect to investment-related regulations and underdeveloped infrastructure, shortages of human resources, and insufficient investment incentives.

IV. A Shift from Market-Driven Regionalization to Institution-Driven Regionalization

East Asia was not active in the formation of regional trade agreements (RTAs), which include FTA and customs union until the turn of the century (Table 8). Indeed, ASEAN Free Trade Area (AFTA), which was established in 1992, was the only major

FTA until Japan and Singapore enacted Japan –Singapore FTA (formally named a New Age Japan-Singapore Economic Partnership Agreement, JSEPA) in 2002. However, the situation changed dramatically in recent years. Many countries in East Asia began to form FTAs with the countries not only in the region but also outside the region. These developments indicate a shift in the importance of drivers of regionalization from market forces to institutional arrangements.

ASEAN has been a hub of FTAs in East Asia, as ASEAN has enacted separate FTAs with China, Korea, and Japan, while it is likely to finish FTAs with Australia-New Zealand, and India soon. In addition to regional FTAs involving ASEAN, several FTAs involving individual members of ASEAN and Japan, China, and Korea have been enacted.

Ideas of a region-wide FTA covering East Asian countries has emerged but no formal attempts have been made to date. Two initiatives involving East Asian countries have been proposed. One is East Asia FTA involving ASEAN+3 (China, Japan, and Korea) and the other is Comprehensive Economic Partnership in East Asia (CEPEA) involving ASEAN+6 (China, Japan, Korea, India, Australia, and New Zealand). Feasibility studies by track-two groups have been under way currently. Although it involves countries and economies outside the East Asia region besides those in the region, the FTAAP, or Free Trade Area of the Asia-Pacific covering 21 APEC member economies, has been proposed by the US.

One notable characteristic of FTAs in East Asia is their comprehensiveness in coverage. As such, some of the FTAs established in East Asia are termed as Economic Partnership Agreement (e.g. Japan-Singapore EPA, JSEPA). These new types of FTAs typically include facilitation of foreign trade, liberalization and facilitation of foreign direct investment (FDI), and economic and technical cooperation, in addition to trade

liberalization, which is included in traditional FTAs. Economic and technical cooperation is given a special attention because narrowing the income gap between the high-income and low-income countries is considered very important for achieving economic prosperity and social and political stability of the region.

Various motives can be identified behind active FTAs by East Asian countries. First, rapid expansion of FTAs in other parts of the world has made East Asian economies realize the importance of establishing FTAs in order to maintain and expand their export opportunities. Indeed, as we saw earlier, substantial import barriers do exist in East Asian countries. Second, countries interested in promoting structural domestic reform to achieve economic growth use FTAs as foreign pressure on the opposition to structural reform, in order to force domestic structural reform. Third, rivalry among East Asian economies over gaining a leadership role in the region has activated their FTA strategies. Both China and Japan, which are competing to become a 'leader' in the region, are keen on using FTAs to strengthen the relationships with ASEAN, Korea and other countries. Fourth, the financial crisis in East Asia in late 1990s increased the awareness among East Asian countries of the need for regional cooperation such as a region-wide FTA to avoid another crisis and to promote regional economic growth. Fifth, countries with active outward foreign direct investment use FTAs to improve business environment in FDI recipient countries, so that Japanese multinational corporations can perform efficiently. Indeed, this motive is one of the most important motives for Japan as many Japanese MNCs have invested in East Asia.

Various studies of the impacts of FTAs on FTA members have shown positive impacts in the form of economic growth and improvement in economic welfare, which is consistent with expectations. Recognizing these positive impacts of FTAs, East Asian countries have a keen interest in promoting FTAs with various countries and establish

region-wide FTAs. However, they have to overcome various challenges including economic and non-economic challenges. The most serious economic challenge is opposition from non-competitive sectors, which are concerned with negative impacts from increased competition. Let me focus on economic obstacles in Japan, which plays an important role in establishing a region-wide FTA. Besides, I would like to argue that the establishment of FTAs is crucial for Japan in order to achieve economic prosperity in the future.

For Japan, the agriculture sector is the most sensitive sector in trade liberalization. Japan has relatively low tariff protection on agricultural products in general, compared to other agricultural product importing countries. What is notable for agricultural protection in Japan is the very high protection given to several products through a complicated protection system, which combines import quotas and high tariffs. For example, the ad valorem tariff equivalent for some selected items are very high as follows: rice (490%), wheat (210%), sugar (270%), butter (330%), and konnyaku potato (990%).

Among these highly protected items, rice is by far the most difficult item to be liberalized because of several reasons. One is its large share of agricultural production, amounting to approximately 25 percent of agricultural production. Another is the geographical location of production spreading over more or less throughout Japan. These two factors result in strong political factor.

Import liberalization of agricultural products has been an obstacle in FTA negotiations for Japan. Japan excluded agricultural products from trade liberalization in their FTAs. Figure 10 indicates high proportion of excluded items for Japan compared to its FTA partners.

The main reason for the difficulty in liberalizing agriculture is its negative impact on employment. It is important to recognize that protection of agriculture sector does not ensure employment of farmers alone, but also the workers engaged in agriculture sector such as construction workers building irrigation systems and workers at farmers' cooperatives. Without overcoming these obstacles and challenges, Japan cannot play a leading role in trade policy formulation in East Asia or achieve its own economic prosperity.

VI. Concluding Remarks

East Asia has been growing rapidly for many years in the post WWII period, as the countries achieved rapid economic growth changed over time. In the last decade, China has been growing extremely fast while other East Asian developing countries, namely the NIEs and ASEAN countries, have been growing not as fast as China but quite favourably. The major impetus behind rapid growth is active expansion of foreign trade and foreign direct investment, which interacted with one another to form regional production network. Rapid expansion of foreign trade and foreign direct investment in turn was attributable to liberalization of foreign trade and investment policies. In order to achieve further economic growth, further liberalization is needed. The optimum method of trade and FDI liberalization is through multilateral negotiations under the WTO. But as the WTO negotiations are facing difficulty, FTAs, especially region-wide FTAs, can be a second-best solution. The positive impacts of the region-wide FTA would be greatly enhanced if it includes economic cooperation.

Japan, being the most developed economy in the East Asian region, is expected to play a leading role in the formation of a region-wide FTA. Besides, for Japan active establishment of FTAs is necessary to achieve economic growth and prosperity. Japan

has to overcome the strong opposition from the agricultural sector. Although it is not easy to do so, there are possible ways. They include adoption of gradual phase-in liberalization scheme, provision of temporary assistance in the forms of income compensation and technical assistance for the improvement of skills, implementation of structural reform in the agriculture sector. These policies can be implemented with strong political leadership.

Finally, I would like to touch on recent economic slowdown in East Asia, resulting from the global financial crisis. The impacts of the global financial crisis have been felt by East Asian countries through two channels, flows of financial resources and goods. To deal with shortage of financial resources, Chiang Mai Initiative of currency swap arrangement has to be expanded and bilateral assistance would also be very helpful. To deal with the decline in exports due to reduced demand in the US and Europe, East Asian countries have to make coordinated efforts by adopting expansionary macroeconomic policies. As to foreign trade and FDI policies, East Asian countries have to maintain open policies. For this purpose, actual steps toward the establishment of region-wide FTAs would be very useful.

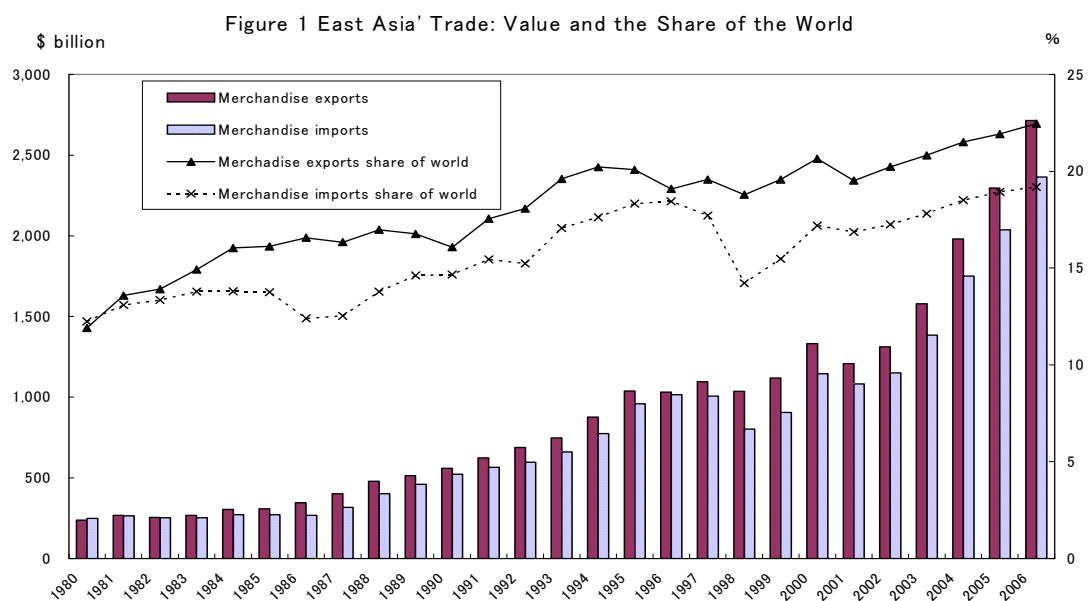


Table 1 Intra-regional Trade Ratio (%)

	1980	2007
East Asia	35.5	52.3
EU	61.3	67.2
NAFTA	33.8	43.0

Figure 2 Country Composition of East Asian Exports

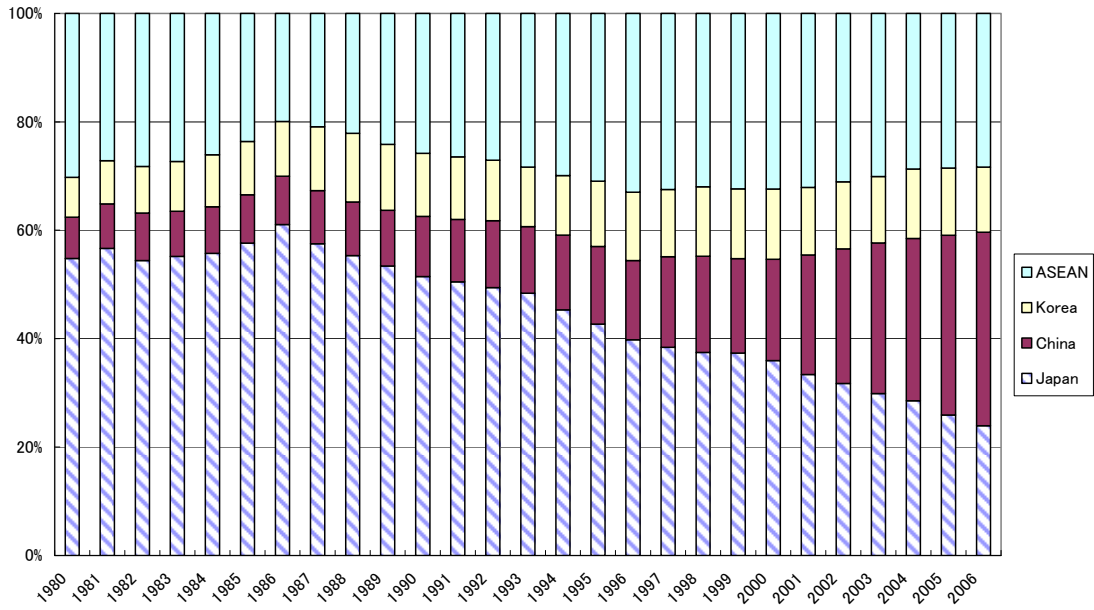


Figure 3 Dependence on China for East Asia's Exports

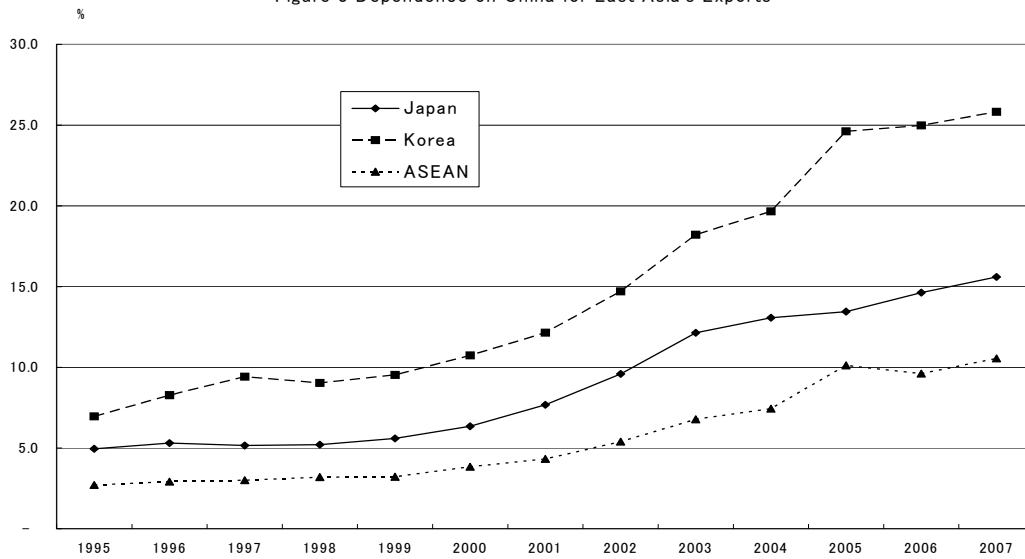


Figure 4 Dependence on Japan for East Asia's Exports

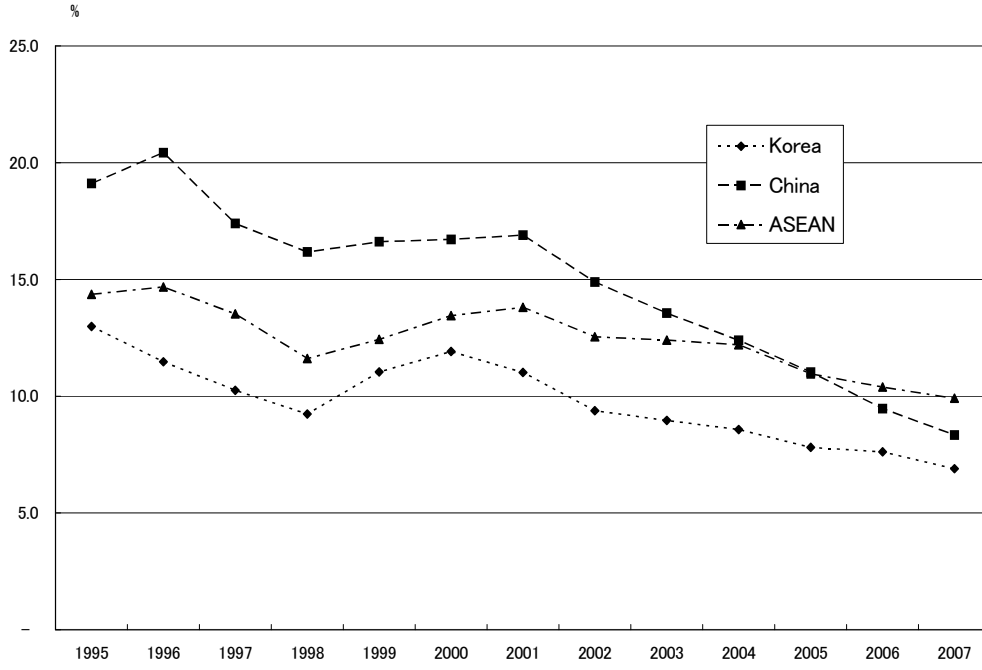


Figure 5 Intra-regional Dependence in East Asia's Exports

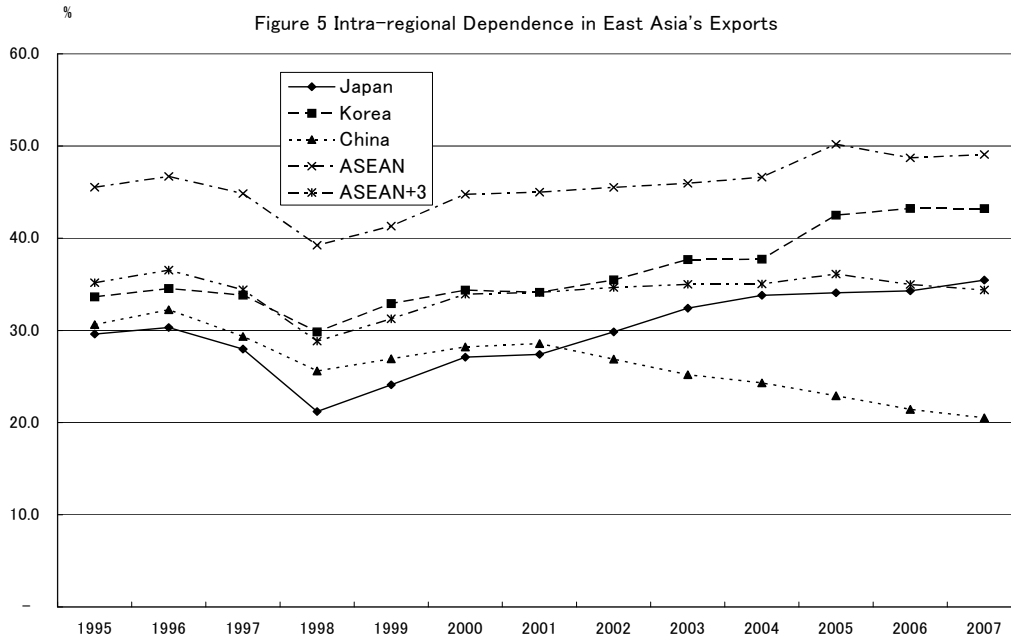


Figure 6 Intra-regional Dependence for East Asia's Imports

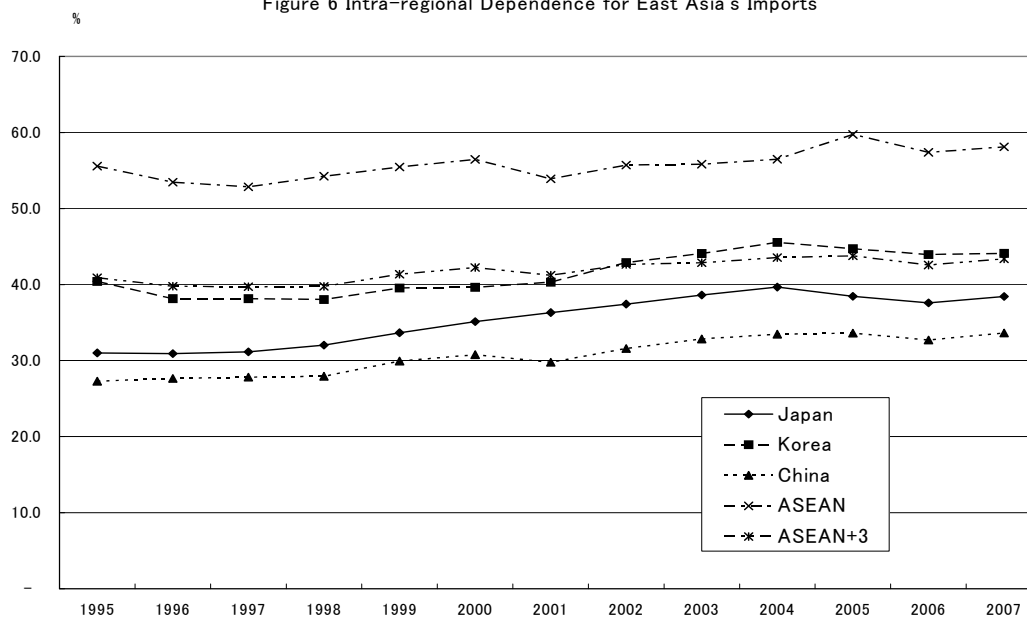
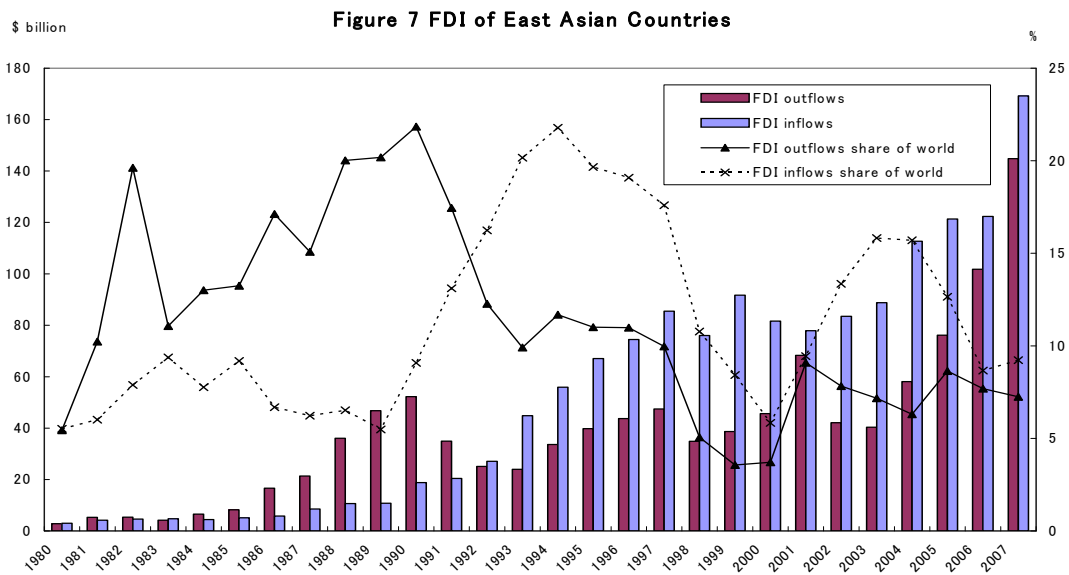


Table 2 Product Composition of Foreign Trade in East Asia

	1990		2005	
	Exports	2005	Imports	2005
Foods	4.3	2.4	8.8	4.8
Textile	9.1	6.9	3.8	2.1
Pulp, Paper and Wood	7.8	5.5	8.5	5.5
Chemicals	6.0	8.0	12.3	14.0
Oil and Coal	6.2	4.8	6.4	5.1
Stone, clay, glass and concrete product	1.4	1.4	2.2	1.4
Iron and steel , Nonferrous metals	6.2	6.5	8.6	8.9
General machinery	14.8	17.8	17.9	18.4
Electrical machinery	16.2	23.3	14.0	24.9
Household electric appliances	6.9	6.2	1.9	2.0
Transportation Equipment	13.1	8.0	9.5	6.9
Precision machinery	1.8	2.7	1.9	4.0
Toys and Miscellaneous goods	6.1	6.5	4.3	2.0
Total	100.0	100.0	100.0	100.0

Table 3 Characteristics of Foreign Trade in East Asia

	With the Rest of the World				Inside East Asia			
	Exports		Imports		Exports		Imports	
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Primary goods	5.7	3.2	11.8	7.7	12.0	5.6	13.3	5.8
Processed materials	23.4	22.3	31.4	28.5	36.7	31.9	36.9	31.3
Parts and componen	18.9	25.6	18.9	31.7	19.7	31.7	18.4	32.1
Capital goods	21.4	24.2	22.1	20.9	17.0	19.1	15.4	18.6
Consumption goods	30.7	24.6	15.8	11.1	14.7	11.7	16.0	12.2



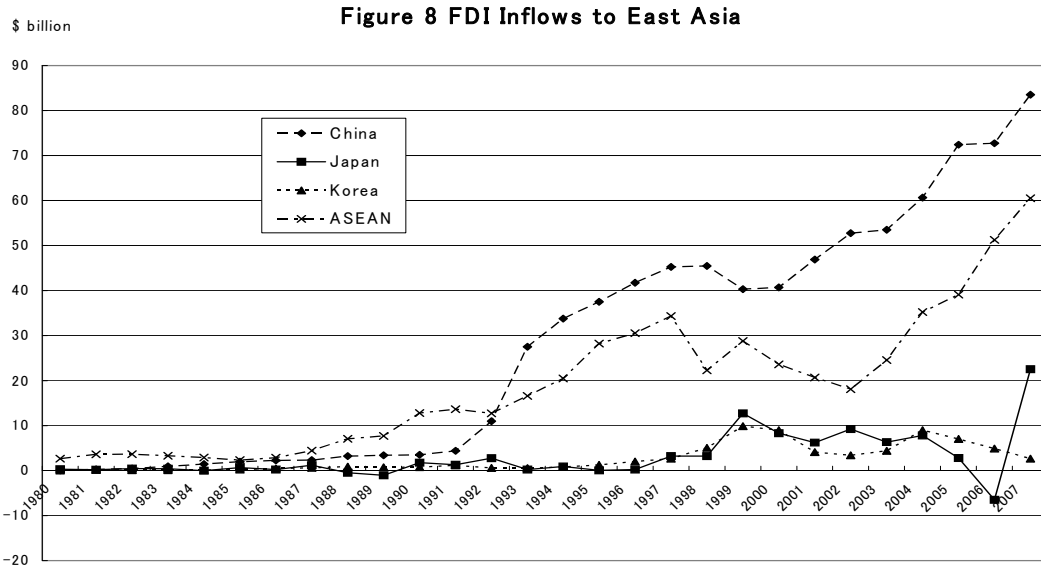


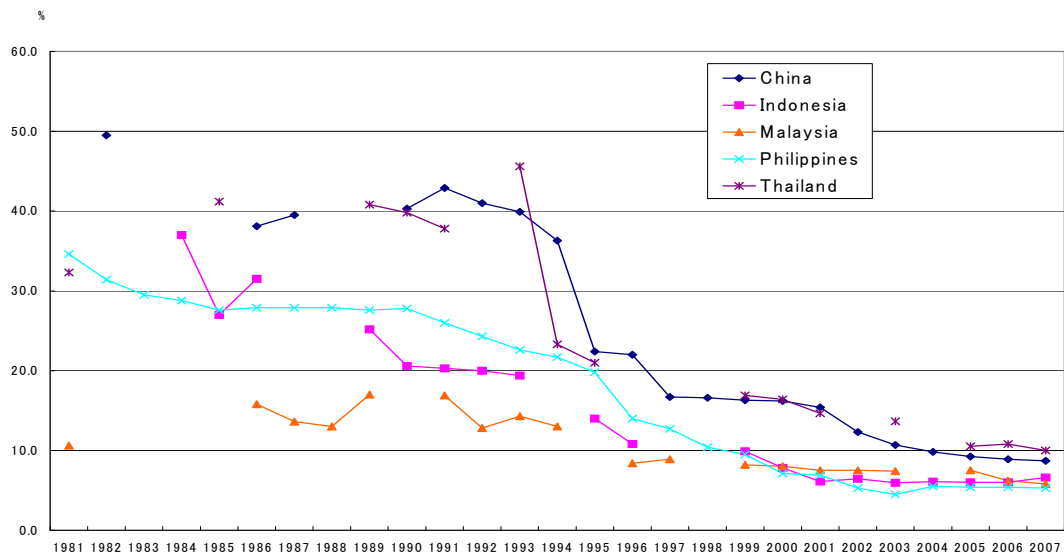
Table 4 Intra-regional FDI Inflow in Total FDI Inflow (%)

	1997-2001	2002-2006
China	19.94	20.74
Japan	1.70	14.27
Korea	22.56	24.51
ASEAN	21.98	32.66
East Asia	19.48	24.56

Table 5 Sectoral Distribution of FDI Inflows in Malaysia and Thailand (%)

	Malaysia	Thailand
	1997-2006	1997-2006
Manufacturing	100.0	100
Food	3.6	5.5
Textiles	1.7	2.0
Wood and wood products	6.1	-
Chemicals	12.1	10.4
Petro chemicals	12.4	2.1
Metal products	9.4	10.5
General machinery	2.3	-
Electric machinery	41.7	24.6
Transport machinery	4.4	31.6
Scientific instruments	2.0	-
Others	4.3	13.3

Figure 9 Tariff Rates



**Table 6 Trade Liberalization:
Reduction in Tariff Rates**

		Total	Primary	Manufactures
China	1992	40.4	36.1	40.6
	2006	8.9	8.9	8.9
Indonesia	1989	19.2	18.2	19.2
	2006	6.0	6.6	5.9
Japan	1988	4.2	8.3	3.5
	2006	3.0	5.0	2.3
Korea	1988	18.6	19.3	18.6
	2006	15.7	21.2	7.3
Malaysia	1988	14.5	10.9	14.9
	2006	6.2	3.0	6.8
Phillipines	1988	28.3	29.9	27.9
	2006	5.4	6.9	5.2
Singapore	1989	0.4	0.2	0.4
	2006	0.0	0.0	0.0
Thailand	1989	38.5	30.0	39.0
	2006	10.8	13.5	10.4

Table 7 Impediments to FDI: Survey Results of Japanese Firms

	Number of incidents	Share by category
<u>FDI liberalization</u>	66	21%
Restrictions on foreign entry	35	11%
Performance requirements	9	3%
Restrictions on overseas remittances and controls on foreign currency transactions	13	4%
Restrictions on the movement of people and employment requirements	9	3%
<u>FDI facilitation</u>	250	79%
Lack of transparency in policies and regulations concerning investment (institutional problems)	64	20%
Complicated and/or delayed procedures with respect to investment-related regulations (implementation problems)	88	28%
Insufficient protection of intellectual property rights	11	3%
Labor regulations and related practices excessively favorable to workers	27	9%
Underdeveloped infrastructure, shortages of human resources, and insufficient investment incentives	53	17%
Restricted competition and price controls	7	2%
	316	100%

Table 8 Major FTAs Involving East Asian Economies (as of December 2008)

In effect		In negotiation	
Bangkok Treaty(1976)	Singapore-India(2005)	Japan-Korea	China-Singapore
AFTA(1992)	China-Chile (2006)	Japan-GCC	Malaysia-Australia
Singapore-NZ (2001)	Korea-Singapore(2006)	Japan-Vietnam	Malaysia-NZ
Japan-Singapore (2002)	Japan-Malaysia(2006)	Japan-India	Malaysia-Pakistan
Singapore-Australia (2002)	Korea-EFTA(2006)	Japan-Australia	Malaysia-US
Singapore-EFTA (2003)	Korea-ASEAN(2006)	Korea-US**	Singapore-Canada
Singapore-US (2004)	Singapore-Panama(2006)	Korea-Canada	Singapore-Mexico
Korea-Chile (2004)	Japan-Chile (2007)	Korea-India	Singapore-Egypt
China-Hong Kong (2004)	Japan-Thailand (2007)	Korea-Mexico	Singapore-Qatar
China-Macao(2004)	China-Pakistan (2007)	Korea-EU	Singapore-Peru
Singapore-Jordan(2004)	Japan-Philippines(2008)	China-Australia	Thailand-EFTA
Japan-Mexico (2005)	Japan-ASEAN(2008)	China-NZ	Thailand-Australia
China-ASEAN(2005)	Japan-Indonesia(2008)	China-GCC	Thailand-India*
Thailand-Australia(2005)	Japan-Brunei(2008)	China-Pakistan	Thailand-US
Thailand-NZ(2005)		China-SACUFTA	

Figure 10 Trade Liberalization Ratio of Japan's FTAs (%)

