



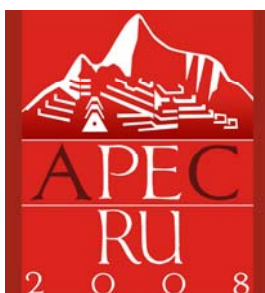
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## **Economic Dimension of the Evolving East Asian Regional Architecture**

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## **Economic Dimension of the Evolving East Asian Regional Architecture**

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### **I. Introduction**

The new regional architecture in East Asia involves two dimensions: economic and political. Both have wide-ranging impact on the management of trade and financial flows in the region and the security relations of countries in East Asia and its ties to the world. This paper will look into the economic dimension of the evolving regional architecture. It will also look into the various initiatives and cooperation agreements that aim to strengthen and substantiate the new regional architecture.

The East Asian region experienced tremendous growth in the past decade. Despite the financial crisis that hit the region in 1997, East Asia bounced back in just a few years with a remarkable growth record, surpassing other regions and firmly establishing itself as a major economic player in the world, along with the United States and Europe. To respond to the changing economic landscape and structures of societies, East Asia increased efforts toward regional integration by strengthening existing institutions that aim to create synergy on trade and financial activities of the economies, while at the same time, creating new institutions that will sustain the growth momentum of the region. These institutions reflect the profound changes taking place in the region and will continue to shape the regional architecture of East Asia in the future.

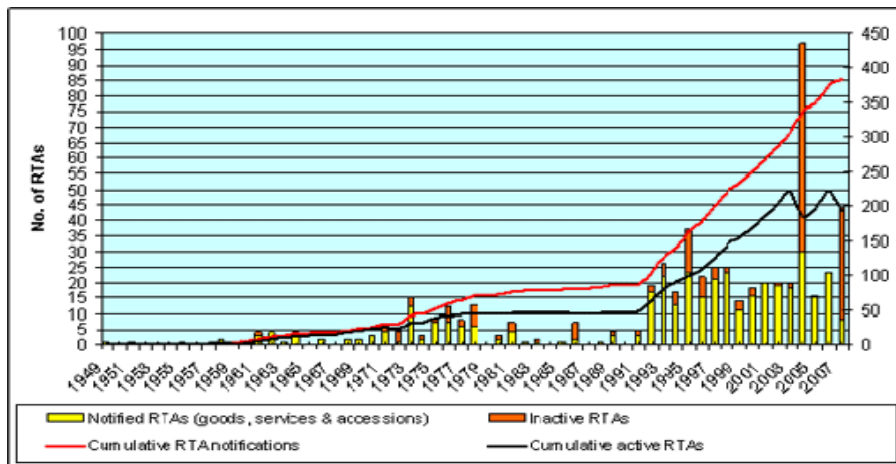
### **II. Economic Dimension of the New Institutional Architecture: Background**

Global economic integration was hastened after World War II, as the period of peace and reconstruction made possible the increase of economic activities. Foreign trade steadily climbed and by 1960, the total ratio of foreign trade to gross domestic product (GDP) stood at 25 percent. Multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT) further quickened globalization, followed by liberalization of trade and investments and improvements in infrastructure and technological developments, creating a climate more conducive for foreign trade.(Urata:2002) Alongside this development was the trend towards regionalism, as countries considered to be natural trading partners coalesce and formed economic blocs. The first manifestation of this regionalism was in Western Europe with the creation of the European Economic Community (EEC) in 1958. This trend continued and by 1994, 124 RTA

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notifications relating to goods had been received under GATT. By 2007, over 240 additional notifications had been received under the WTO regime.



Evans et al<sup>2</sup> analyzed the evolution of the global economic architecture through the evolution of economic blocs that formed after World War II, specifically the formation and expansion of economic blocs that dominated trade activities globally. Formation of these economic blocs continued to evolve since the 1960s as a result of various economic and political events that enabled so-called natural economic groups and strategic partners to gravitate toward each other.

The 1960s was characterized by a bipolar economy, with the US and Europe dominating global trade. A number of closely connected developing countries were linked to the dominant blocs, which either were formed because of geographic proximity, or were former colonies, or had developed a strategic partnership in the course of the cold war. The two leading world trade blocs accounted for 80% of global trade. The European bloc was closely linked with countries in Africa and former colonies. On the other hand, the United States linked with Latin America and countries and the Philippines. Britain still retained leadership in small Asian cluster consisting of former colonies, China and the rest of the Middle East. Notably, the dependent developing countries traded much more with Europe or the United States and not as much among themselves.

A realignment of global trading pattern took place in the 1970s, creating three distinct blocs and two clusters, with more fragmentation in trading arrangements. It showed splintering

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<sup>2</sup> Evans, David, et al. A Framework for Evaluating Regional Trade Agreements: Deep Integration and New Regionalism. University of Sussex, 2004.

from the previous European and US-centred blocs of the early European and US blocs and increasing diversification of trade by countries formerly linked with either Europe or the US. It also marked the emergence of East and Southeast Asia as a new trade bloc and a major player in the world market as it captured a larger share in total world trade. The changes were triggered by the continuing GATT trade rounds and the onset of unilateral trade policy liberalization associated with structural adjustments in these countries.

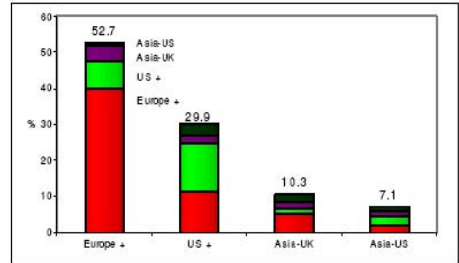
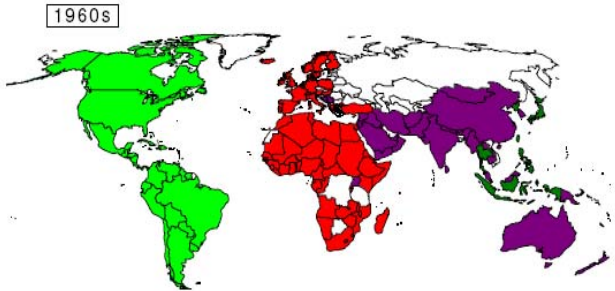
The 1980s reinforced the developments in the previous decade and marked the emergence of East Asia as an important trade bloc. It instigated the emergence of East Asia as a major economic player. The East Asian economic bloc expanded its membership later on to include Australia and New Zealand, increasing its total world trade share.

It was also during this decade that the South American bloc started to gain momentum. Argentina, Paraguay and Uruguay increased their trade shares with one another and with Brazil. Brazil also increased its trade share in the region. African trade was also gaining strength as trade with South Africa and its near neighbours, Malawi and Zimbabwe, expanded.

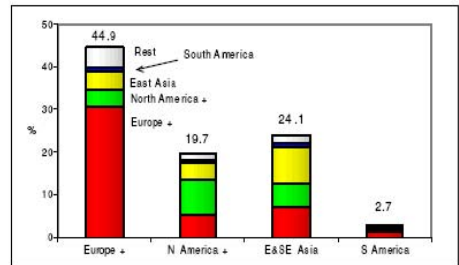
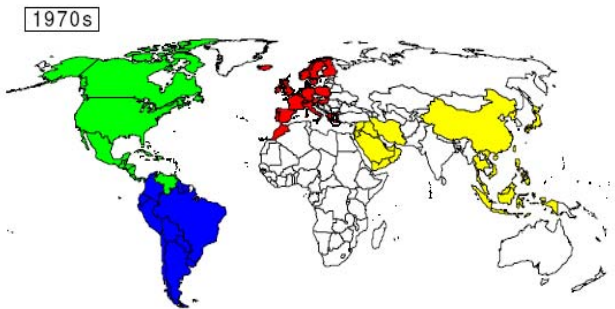
The 1990s consolidated the gains from the previous decades and the importance of East Asia became firmly established as an economic bloc, changing the global economic landscape from bipolar to tri-polar with the emergence of the East Asian region as the third bloc, along with EU and North America. With the break up of the Soviet Union, trade also started to gravitate towards Europe. Over time, two new blocs also appeared the Mercosur and a group around South Africa. Trading patterns and economic relations between and among the different blocs also became more diversified and intensified.

# Evolving Economic Blocs

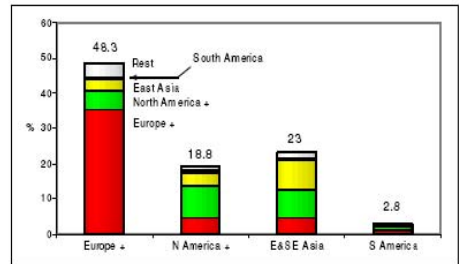
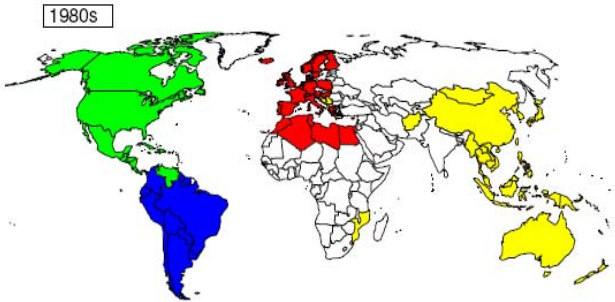
In the 1960s, the European Union and United States dominate trade ...



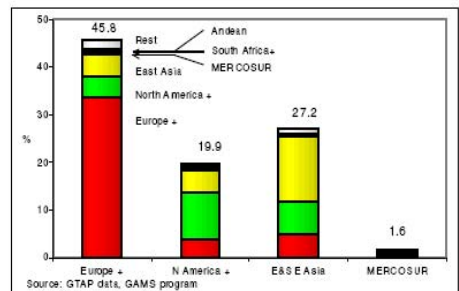
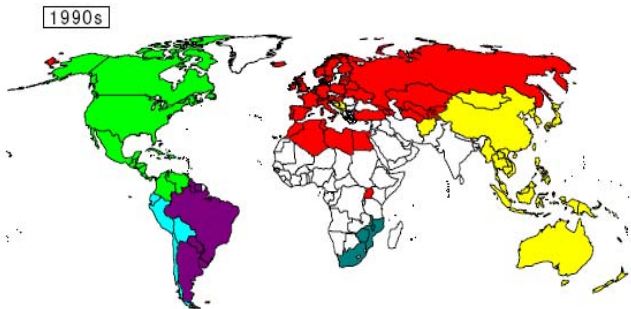
... but by the 1970s, Japan and Korea begin to lead an East Asian bloc...



... a decade later, the East Asian Tigers, ASEAN countries, and Australia consolidate the East Asia bloc...



and in the 1990s, ECA emerges and East Asia trades more with itself than with the U.S. and EU.



Source: Robinson and Diaz Bonilla 2004.

### III. Rising East Asia: The New Economic Powerhouse

The growth and deepening integration of the East Asian economy is the result of three huge waves of trade and industrial transformation. The First wave occurred with the rise of Japan and its emergence as a major industrial power. The Second wave was led by the newly industrializing economies (NIEs) of Northeast and Southeast Asia in the late 1970s and 1980s. The third wave was brought by the rise of China. These three major events restructured the economic architecture of East Asia, making it an economic powerhouse and cornering almost a quarter of world output. (Drysdale, 2005)

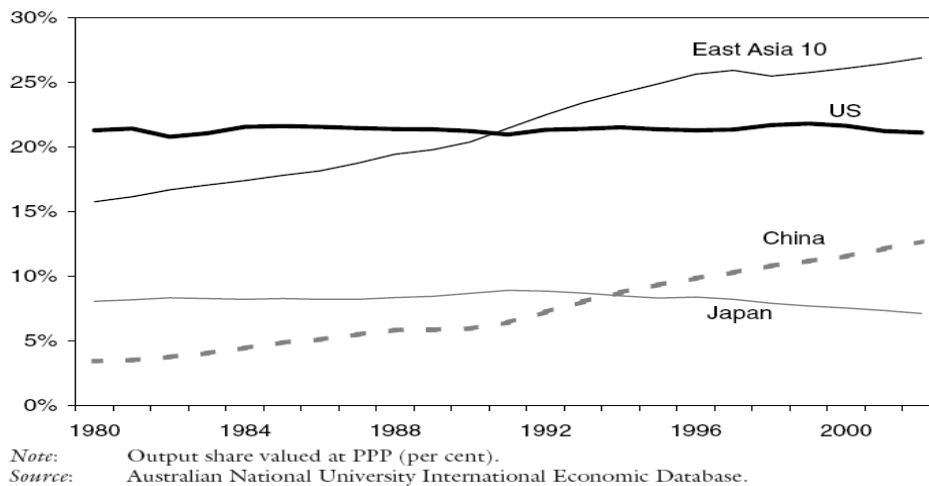
|                   | 1991-1993 | 1994-1996 | 1997-1999 | 2000-2002 |
|-------------------|-----------|-----------|-----------|-----------|
| East Asia 10      | 22.3      | 23.8      | 22.8      | 22.5      |
| China + Hong Kong | 3.7       | 4.5       | 4.8       | 5.6       |
| Japan             | 9.1       | 8.3       | 7.2       | 6.7       |
| Korea             | 2.2       | 2.6       | 2.5       | 2.6       |
| Taiwan            | 2.3       | 2.3       | 2.2       | 2.3       |
| ASEAN 5           | 5         | 6.2       | 6         | 6.1       |

Source: Australian National University International Economic Database

While East Asia still has obstacles to hurdle in terms of human resource development, infrastructure, and governance, it has undoubtedly taken an important role in the global economy. East Asia's share of world output had risen substantially over the past two decades, overtaking the United States by 1993 and capturing a large size of world exports, matching that of North America. (Drysdale:2005:5)

Figure 1

East Asian share in world output



East Asia has grown more rapidly and steadily than any other region in the world, taking a peak on the years before the Financial Crisis at 9.4% (Table 2). As a result of this growth, it is estimated that more than 95 percent of the region’s population will be living in middle-income countries by 2010. The growth experience has been strong and steady, and except for the Philippines, developing countries in East Asia experienced more than 30 years of consistent above 2% growth --- growth record no other developing region experienced for the past 40 years. (Table 3) (Gill and Kharas, 2007).

**Table 2. East Asia Has Been Growing More Rapidly Than All Other Regions**  
*percent GDP growth, 1980-2004*

| Region                           | 1980-84 | 1985-89 | 1990-94 | 1995-99 | 2000-04 |
|----------------------------------|---------|---------|---------|---------|---------|
| East Asia and the Pacific        | 7.2     | 7.8     | 9.4     | 6.8     | 7.2     |
| Latin American and the Carribean | 1.4     | 2.2     | 3.6     | 2.4     | 2.2     |
| Europe and Central Asia          |         |         | -5.2    | 2       | 5.2     |
| Middle East and North Africa     | 3.8     | 1.2     | 4.6     | 3.4     | 4.4     |
| South Asia                       | 5.4     | 6.0     | 5.0     | 5.8     | 5.6     |
| Sub-Saharan Africa               | 1.6     | 2.4     | 0.6     | 3.6     | 3.4     |

Source: Gill and Kharas, 2007

**Table 3. East Asian Growth Has Been Strong and Steady**

per capita growth, percent, 1966-2004

| Region                          | Growth | Number of years in which the rate was: |      |          |
|---------------------------------|--------|--|------|----------|
|                                 |        | Negative                               | 0-2% | Above 2% |
| East Asia and the Pacific       | 5.77   | 2                                      | 3    | 34       |
| China                           | 7.00   | 3                                      | 3    | 33       |
| Indonesia                       | 4.03   | 4                                      | 3    | 32       |
| Malaysia                        | 3.95   | 5                                      | 3    | 31       |
| Philippines                     | 1.28   | 6                                      | 21   | 12       |
| Thailand                        | 4.79   | 3                                      | 5    | 31       |
| Latin America and the Caribbean | 1.46   | 10                                     | 15   | 14       |
| Middle East and North Africa    | 1.23   | 8                                      | 13   | 9        |
| South Asia                      | 2.56   | 1                                      | 12   | 26       |
| Sub-Saharan Africa              | 0.18   | 14                                     | 20   | 5        |
| OECD                            | 2.49   | 0                                      | 18   | 21       |

Source: Gil and Kharas, 2007

Trade has been East Asia's economic lifeblood for the past decades and its source of growth. It had shown tremendous growth in intraregional trade and investment flows much more than any other regions in the world. Since the financial crisis, the exports doubled and had steadily grown even beyond 2004, accounting for more than 20% of total world exports. (Table 4)

**Table 4. East Asia is a Trade Powerhouse**

merchandise exports, current US\$

| Region                            | Value US\$ Billion |         |          | Share of world total % |       |       |
|-----------------------------------|--------------------|---------|----------|------------------------|-------|-------|
|                                   | 1990               | 1998    | 2004     | 1990                   | 1998  | 2004  |
| Emerging East Asia                | 427.7              | 939.0   | 1,847.6  | 12.3                   | 17.1  | 20.2  |
| Australia, Japan, and New Zealand | 336.7              | 455.9   | 672.6    | 9.7                    | 8.3   | 7.4   |
| North America (3)                 | 521.3              | 896.5   | 1,135.40 | 15                     | 16.3  | 12.4  |
| Eastern Europe (12)               | 34.5               | 119.0   | 291.2    | 1.0                    | 2.2   | 3.2   |
| Rest of Europe (28)               | 1,623.00           | 2,383.5 | 3,718.10 | 46.7                   | 43.3  | 40.7  |
| Former Soviet Union (15)          | n.a.               | 115.6   | 284.9    | n.a.                   | 2.1   | 3.1   |
| Memo European Union (25)          | 1,535.2            | 2322.4  | 3760.8   | 44.2                   | 42.2  | 40.6  |
| Middle East (14)                  | 138.4              | 144.5   | 389.6    | 4                      | 2.6   | 4.3   |
| North Africa (7)                  | 38.6               | 34.4    | 82.8     | 1.1                    | 0.6   | 0.9   |
| Sub-Saharan Africa (48)           | 68.2               | 71.8    | 143.7    | 2                      | 1.3   | 1.6   |
| World                             | 3475.1             | 5,504.4 | 9,145.0  | 100.0                  | 100.0 | 100.0 |

Source: Gill and Kharas, 2007

Note: n.a.=not applicable

The number of countries is shown in parentheses

Another interesting trade pattern for East Asia is that intraregional trade has expanded more rapidly than extraregional trade, with 49% of exports sourced from intraregional trade. The growth is a result of the countries boosting their share of exports to China. On the other hand, East Asian countries showed falling export shares to Japan for the past ten years. (Table 5)

Much of this regional trade is accounted for by a triangular pattern of exports, or the back-and-forth trade in intermediate goods, whereby additional processing is undertaken at each stage until the final product is exported, usually to the United States, Europe and Canada.

**Table 5. Growth of Intra-regional Export in East Asia**  
*percent of total exports going to East Asia, China and Japan*

| Exporter        | East Asia |         | China   |         | Japan   |         |
|-----------------|-----------|---------|---------|---------|---------|---------|
|                 | 1990-94   | 2000-04 | 1990-94 | 2000-04 | 1990-94 | 2000-04 |
| East Asia       | 44.1      | 49.0    | 6.4     | 11.1    | 8.6     | 8.2     |
| China           | 60.5      | 45.3    | n.a.    | n.a.    | 15.8    | 14.3    |
| Hongkong, China | 47.0      | 55.5    | 29.9    | 39.3    | 5.4     | 5.4     |
| Indonesia       | 62.0      | 56.9    | 3.6     | 5.4     | 32.9    | 21.0    |
| Japan           | 34.6      | 43.1    | 3.7     | 10.0    | n.a.    | n.a.    |
| Korea, Rep. of  | 40.8      | 46.6    | 4.2     | 15.6    | 15.7    | 9.8     |
| Malaysia        | 54.7      | 54.2    | 2.5     | 5.3     | 13.6    | 11.5    |
| Philippines     | 36.1      | 53.7    | 1.2     | 4.2     | 17.4    | 16.4    |
| Singapore       | 48.2      | 56.4    | 2.0     | 6.1     | 7.8     | 7.0     |
| Taiwan, China   | 42.7      | 55.2    | 0.0     | 10.3    | 11.3    | 9.2     |
| Thailand        | 41.7      | 48.3    | 1.5     | 5.3     | 17.3    | 14.7    |
| Vietnam         |           | 49.0    |         | 9.6     |         | 15.7    |

Source: Gill and Kharas, 2007

#### IV. The Evolving East Asian Regional Economic Architecture

Various factors led to the industrial and trade transformation of East Asia over the last half century. This created the opportunity to more dynamically link the economies in the international production chain and also provided an environment conducive for foreign direct investment (FDI) flow.

The initial phase of liberalization took place in the 1980s and 1990s, as countries in East Asia embarked on unilateral liberalization of trade and FDI policies and deregulation in domestic economic activities. This is part of their commitments to World Bank and IMF for more comprehensive structural reform policies in exchange for obtaining economic assistance, and also from the realization on the part of the East Asian countries that liberalization and deregulation would promote economic growth. Economies unilaterally liberalized their tariffs and non-tariff barriers from the 1980s to 2000s.

Meanwhile, policies towards FDI liberalization started around mid-1980s as countries began to realize that FDI inflows would promote economic growth. Some of the measures undertaken were reduction of the number of sectors and industries on the negative list and relaxing the limits on foreign equity ownership. A number of economies also introduced tax holidays or tax breaks to encourage more FDI inflow. (Urata:2008:15).

In the 1990s, as regionalization developed, liberalization of trade and FDI also further progressed in East Asia. In 1992, ASEAN member countries created the ASEAN Free Trade Area (AFTA), purposely to enhance trade and FDI flow in the region. AFTA remains to be considered as the centrepiece of the ASEAN economic integration policy. The agreement provided for the liberalization of tariff and non-tariff measures under the Common Effective Preferential Treatment (CEPT) Scheme that at present covers 65,529 tariff lines, 84% of which is in the inclusion list. As this scheme is enthusiastically embraced by member countries, , the ASEAN-6

realized the target of 0-5 percent tariff level, covering 95.7 percent of tariff lines and 90 percent of intra-ASEAN trade in goods. This was accomplished in 2002, six years ahead of its intended schedule in 2008. ASEAN targets 2010 to become a complete free trade area, except for the CMLV which are given deadlines at a much later date.

Another regional framework that facilitated trade and FDI liberalization in East Asia is the Asia Pacific Economic Cooperation (APEC) forum. APEC provided the venue for East Asian countries to engage North and South America and Oceania to engage on economic dialogue and other issues vital to economic development in the region. While its basic principle is based on voluntarism, the Bogor goals calling for full liberalization of trade and FDI by 2010 for developed economy members and by 2020 for developing economy members had been well integrated in member countries' economic agenda. Evidently, all member countries have made significant strides in freeing trade and FDI regimes.

Several studies had been devoted to understand the shape of East Asia's economic architecture. (Kawai, 2007; Urata, 2005; Soesastro, 2006; Nanto, 2008). It has been argued that the evolution of East Asia's economic architecture has been propelled by three factors: i) market-driven economic integration, ii) negotiated trade liberalization initiatives, and the iii) regional financial cooperation initiatives following the Asian Financial Crisis. The East Asia integration process started as market-led integration and has progressed into an institution-led process with the proliferation of regional trade agreements and financial cooperation initiatives.

#### ***a. Market-driven economic integration in East Asia***

Several analysts agree that the initial phase of economic integration in East Asia was created by market-driven forces of cross-border trade, FDI and finance. The simultaneous expansion of and reinforcement between trade and FDI, or what has been referred to as the trade-FDI nexus, (Urata:2005; Kawaii:2005) was largely determined by the establishment of regional production networks and supply chains by multinational corporations, otherwise known as "Factory Asia" (Soesastro:2006). By the end of 1990s, the intensity of regional trade in East Asia is already comparable to that of EU and NAFTA. East Asia is also slowly veering away from its dependence on the American and European markets. This dependence is expected to decline as demand for final products within East Asia continues to grow. (Kawai:2007)

On the other hand, rapid FDI inflow in East Asia is largely attributable to favourable economic environments and the abundant supply of high-quality, low wage labor. FDI inflows to East Asia over the past decades have grown rapidly, even at a rate much faster than the region's growth in trade. By 2006, East Asia accounts for 13% of the total global FDI inflow and 12% of total outflow. As discussed, many of these FDI movements were intraregional – from Japan and the NIEs, to ASEAN and PRC, and from ASEAN and to PRC. Multinational manufacturing corporations played an important role in enhancing economic integration. Initially, these MNCs

were from Japan, Europe and United States, and were later on followed by MNCs from emerging economies in East Asia. These MNCs had been instrumental in linking East Asia in the global production chain as they divide their production process into several sub-processes and relocating these in different countries in accordance to their comparative advantage. Such business arrangements have promoted vertical intra-industry trade within East Asia in capital equipment, parts and components, intermediate inputs, semi-finished goods, and finished manufactured products. (Kawaii:2007:2-3) This development shows the important role of FDI in integrating the region and spurring economic growth.

China plays a key role in the international product fragmentation and the regional production network in general. China's dynamic role on intra-regional trade has changed the structure of East Asia, and to a large extent created a positive boost to ASEAN as it tries to keep up with competition from China.

China shows bigger influence in the region as it poses to capture a substantial portion of FDI inflow and outflow and bolstered intra-industry and intraregional trade growth. About half of the increase in East Asia's share in world trade has been accounted for by China. The rise of China has further expanded "Factory Asia" and established what is referred to as the new pattern of "triangular trade" involving increased Chinese imports from East Asia and Chinese exports to third markets. (Soesastro, 2006)

In addition to trade and investment integration, financial markets are also rapidly integrating as a result of deregulation of domestic financial systems, opening of financial services, and progressive relaxation of capital and exchange control. Commercial banks in developed countries operated abroad and portfolio investments have significantly strengthened linkages among the region's financial markets. At the same time, commercial banks in emerging economies have also expanded operations to their neighbours. However, compared to trade and FDI integration, financial integration in East Asia has been less pronounced because apart from Japan, Hongkong, China and Singapore, most East Asian economies still impose capital and exchange restrictions and other barriers, which impede free flows of financial capital. Moreover, many of these emerging East Asian economies still have underdeveloped financial systems that are unable to attract investors. (Kawai, 2007).

#### ***b. Negotiated Trade Liberalization Initiatives: Proliferation of Free Trade Agreement in East Asia***

East Asia is currently one of the most active regions engaged in FTA. As of May 2008, twenty eight FTAs have been in effect, while thirty six are currently in negotiation (two of which are waiting for ratification from their respective legislative bodies and four had reached conclusion). (Table 6)

The growth of bilateral agreements in East Asia is also a response to the sluggish progress of the WTO rounds of negotiation, as FTAs proved to be more convenient and conclusion usually comes swifter, and provided more flexibility in scope. There is also on-going trend to seek partnership outside of the region. ASEAN had sealed partnerships with non-East Asian countries, particularly Australia, India and New Zealand. It is also currently considering negotiating an FTA with the European Union. Likewise, a number of ASEAN-member countries had tied bilateral FTA with countries outside of the region. Japan and PRC had also been actively engaged in bilateral agreements, with Japan becoming one of the most dynamic FTA movers in the world.

Kawai (2007) sums up the characteristics of these East Asian FTA into either bilateral (between two countries) or plurilateral (agreement among three or more countries); outwardly oriented (seeking partnership outside of the region); with WTO plus coverage or covering issues beyond trade and services liberalization, most especially economic and technical cooperation; and consisting of multiple rules of origin as most FTAs in East Asia take on a combination of three types of ROO rather than applying a single rule<sup>3</sup>.

He also added that East Asian FTAs typically cover issues beyond trade and services liberalization. Japan's bilateral initiative, called the Economic Partnership Agreement (EPA), has been referred to as "new age FTA" as it goes beyond trade and investment liberalization, to include trade facilitation and cooperation. China's bilateral FTA with individual ASEAN countries likewise focus on economic and technical cooperation, with a more lenient schedule for tariff liberalization. This type of FTA aims to address the asymmetry in economic size and development between partner countries.

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<sup>3</sup> The three types of Rules of Origin are: i) change in tariff classification (CTC) rule defined in detail at a Harmonized System level; ii) a local or value content (or value added) rule requiring a product to satisfy a minimum local or regional value added in the exporting country or region of an FTA; iii) specific process (SP) rule requiring a specific production process for an item.

**Table 6**

**Major FTAs Involving East Asian Economies as of May 2008**

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

Source:Urata, 2008

Notes:\*\* indicates that treaty has been signed and waiting for ratification of respective legislative bodies. \*indicates that the negotiation reached an agreement

Urata (2008) cited the following reasons behind the surge of FTAs in East Asia:

1. *To keep up with the rapid expansion of FTAs in other parts of the world.* This is one way for countries to prevent trade discrimination by maintaining and expanding export opportunities;
2. *To promote domestic structural reforms.* FTA could help create the pressure to lock in structural reforms to achieve economic growth;
3. *To avoid another crisis similar to that of the 1997 Financial Crisis.* Countries in East Asia became urgently aware of the need to work together closely Crisis; and
4. *As a response to rivalry among East Asian economies over market access in potential FTA partners' market as well as competition for leadership role in the region.* This is especially evident with Japan and China as both aggressively pursue stronger

relationship with Korea and ASEAN. In the same note, ASEAN and Korea also use FTA to increase their influence in East Asia.

### **c. Regional Financial Cooperation and Integration**

To strengthen the regional financial architecture, several financial cooperation and integration initiatives have been undertaken in the region. A few months before the financial crisis hit the region in 1997, ASEAN Finance Ministers convened, as if on premonition to the crisis, and agreed to work together on three important issues: strengthening the supervisory and regulatory framework of the banking sector; liberalize the financial services; and evaluate the utility of the ASEAN Swap Arrangement. (Soesastro, 2006).

Following the Asian Financial Crisis, interest on financial cooperation intensified. Efforts towards increased risk allocation made East Asia as the first region to actively pursue measures to establish a group based on monetary and financial cooperation. The regional economies thus embarked on several initiatives to strengthen the regional financial architecture, consisting of three pillars: regional economic surveillance, liquidity support facility, and the Asian Bond market development. (Kawai, 2007)

Several regional surveillance measures had been launched in East Asia following the financial crisis. The most prominent, to date is the ASEAN + 3 finance ministers' Economic Review and Policy Dialogue (ERPD) process launched in May 2000. ASEAN + 3 ERPD aims to prevent another financial crisis by creating channels for information sharing, exchange of views, assessment of economic conditions and policies, and potential for collaboration on financial, monetary, and fiscal issues of common interest.

Meanwhile, the Chiang Mai Initiative is considered to be the centrepiece of the liquidity support facility in East Asia and aims to address short-term liquidity needs in the event of a financial crisis or contagion and to supplement the existing financial arrangements. The CMI has two elements: the ASEAN Swap Arrangement (ASA), and the network of sixteen bilateral swap arrangements (BSAs) among 8 ASEAN+3 members. Programs to link CMI with IMF programs are currently underway to supplement the region's limited capacity to produce and enforce adjustment programs in times of crisis.

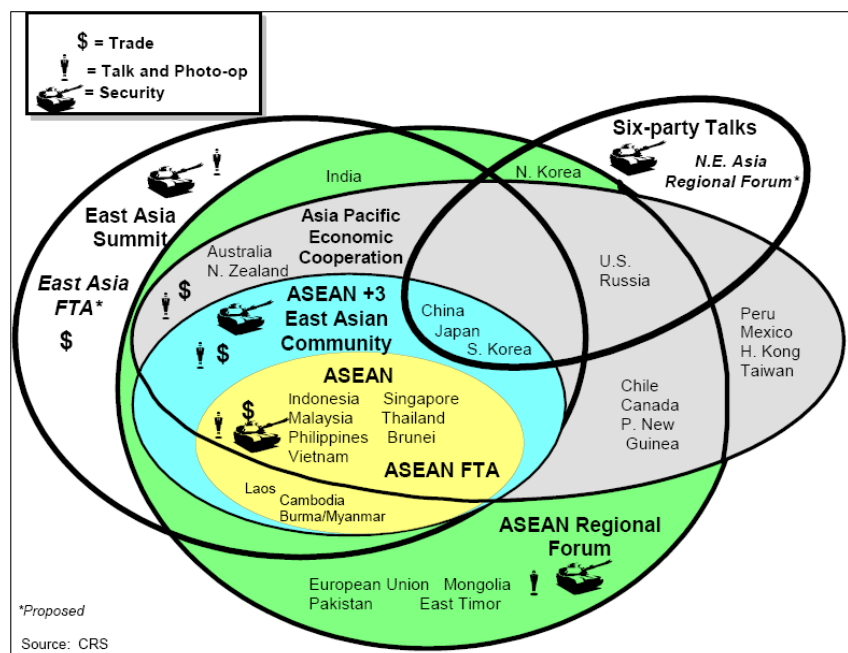
The idea of creating a regional bond fund came after the Financial Crisis as East Asia saw the need to develop local currency bond markets as an alternative source of financing to lessen the region's heavy dependence on banks. The basic idea is to create a channel to mobilize the region's vast pool of savings to be intermediated directly to the region's long-term investment, without going thru the financial centers outside of the region. Among the initiatives undertaken at the regional level are the Asian Bond Fund (ABF) initiative and the Asian Bond Markets Initiative (ABMI). Both are under the auspices of EMEAP (Executives' Meeting of East Asia

and Pacific Central Banks) and ASEAN + 3 finance ministers. Alongside these initiatives are the APEC finance ministers' process and the Asia-Cooperation Dialogue (ACD) process which aim to support the Asian bond market development.

## V. Institutions that Shape East Asia's Future

The East Asian region is engaged in various economic, political and security arrangements that aim to influence the priorities and policy direction of the region. The figure below shows the current and proposed institutional arrangements in East Asia. At the heart of the East Asian economic integration is ASEAN, ASEAN + 3 and ASEAN + 6 or the East Asia Summit (EAS). Analysts believe that they will take the lead role in shaping the economic future of the region, with ASEAN as the driving force, ASEAN + 3 as the main vehicle for the realization of the East Asian community, and the East Asia Summit as an integral part of the evolving regional architecture. (Kawai, 2007)

**Figure 2. Major economic, political and security institutions in East Asia**



## *A. The core institutions of East Asia: ASEAN, ASEAN + 3 and the East Asian Summit<sup>4</sup>*

### 1. ASEAN Economic Community

The Association of Southeast Asian Nations or ASEAN was established in 1967 with five original members: Indonesia, Malaysia, the Philippines, Singapore and Thailand. Brunei joined in 1984, Vietnam in 1995, Laos and Burma in 1997, and Cambodia in 1999.

In 1992 ASEAN seriously pursued efforts to integrate the economies, when creating the ASEAN Free Trade Area (AFTA), considered to be the centrepiece of the ASEAN economic initiative. To supplement AFTA, it also launched other initiatives such as AFAS (ASEAN Framework Agreement on Services), and the ASEAN Investment Area (AIA). AFAS was signed in 1995 and aims to enhance trade in services within ASEAN by eliminating intra-ASEAN restrictions to trade and free flow of services by 2015, by improving market access and guaranteeing national treatment to ASEAN nationals. The AIA, on the other hand, was signed in 1998 and aims to make ASEAN a competitive region by eliminating investment restrictions and creating an environment more conducive for free flow of investments, capital, technology, professional expertise and skilled labor.

ASEAN has devoted efforts to solidify the region's goal of creating a peaceful, stable and prosperous community by issuing declarations and statements in support of these goals. In 2003, the ASEAN leaders adopted the "Declaration of ASEAN Concord II", whereby they agreed on creating an ASEAN Community by 2020 comprising of three pillars: an ASEAN Security Community, an ASEAN Economic Community and an ASEAN Socio-Cultural community.

The vision is to create a competitive region by 2020 with a free trade area with a single market and production base, where investments and capital move freely, and where the gains from economic development are equitably distributed, poverty reduced and socio-economic disparities are lessened. To realize the end goal of the ASEAN Vision 2020, the ASEAN leaders adopted the "Vientiane Action Program" (VAP), a six-year plan (2005-2010), that aims to deepen integration and narrow the development gap within ASEAN, particularly of the least developed country member countries of Cambodia, Lao PDR, Myanmar and Vietnam (CMLV).

### 2. ASEAN + 3.

Launched in 1999, ASEAN + 3 served as platform for a more interactive dialogue in various fields and sector of interest to the region, ranging from foreign affairs, economy and trade, health, science, social welfare issues and others. Originally, ASEAN + 3 came about as a result of Japanese proposal to create a regular summit process between ASEAN and Japan, with an agenda that included security. Concerned with the response of other countries in East Asia, ASEAN broadened it to include China and South Korea. Currently, the ASEAN + 3 members

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<sup>4</sup> This section is drawn from Kawai (2007)

meet regularly after the ASEAN Summit to discuss issues pertaining to finance, economic and security. It also serves as a forum for finance ministers to discuss issues on financial cooperation. In 2004, the ASEAN + 3 leaders created the “East Asian Community” which was agreed to be the vehicle for a more progressive integration of the East Asian community.

3. East Asia Summit (ASEAN + 6). The East Asia Summit was officially convened on December 14, 2005 in Malaysia and brought together the ten ASEAN nations, the “plus three” states of China, South Korea and Japan, and then Australia, New Zealand and India. Japan is known to be an enthusiastic supporter of the East Asia Summit and regards this is a more appropriate grouping for economic cooperation. As of the 2007 meeting, ASEAN + 6 decided to focus on five priority cooperation areas: energy, education, finance, avian flu and natural disaster mitigation.

#### *B. Trans-regional economic forum in East Asia*

##### 1. APEC

Established in 1989, APEC has played an important role in encouraging trade and investment liberalization within the Asia-Pacific region and in providing a platform for dialogue between North America and East Asia. Considerable achievement was also accomplished in liberalization by APEC-member countries as the Bogor goal of achieving zero-tariffs by 2010 for developed countries and 2020 for developing countries is getting close. With the US’ proposal for an FTA for members, there has been renewed interest in APEC, although some members think that an FTAAP would contradict APEC’s voluntary, non-binding and open regionalism principles.

##### 2. ASEM

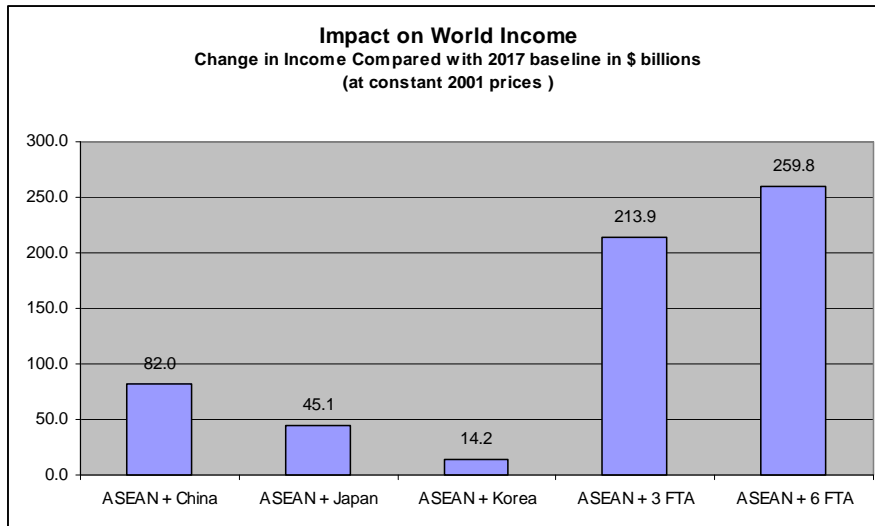
Although not as active as APEC, ASEM could potentially be an important forum for Asia-European Union economic cooperation. Its membership initially covers all ASEAN members, the PRC, Japan, Korea, and EU members, and more recently India and Pakistan.

## **VI. Issues and Challenges**

The East Asian community has created a web of networks and institutions that need to be consolidated and tightened systematically to function efficiently. Kawai (2007) wrote that the best way to move forward is to first unite overlapping FTAs into a single East Asian Agreement, covering ASEAN+6 or the EAS countries, with ASEAN as the regional hub so that the “noodle bowl” effect are minimized and “deep integration” could really be achieved. Estimates show that FTA consolidation at the ASEAN + 6 level would yield the largest gain compared to other regional trade arrangements. (Figure 3) Further, he added that the single East Asian FTA must be mindful of coherence of rules, WTO consistency and should eventually be linked with North America and Europe. He also emphasized the need to strengthen regional cooperation such that

in the event of another liquidity crisis, East Asia will have the means to independently handle the crisis. Greater coordination and harmonization between concerned government agencies are needed in this regard.

Figure 3



Source: Kawai and Wignaraja. As cited in the Far Eastern Economic Review, April 2008

With ASEAN taking a key role in consolidating the various regional economic groups, efforts towards addressing the supply side constraints of the poorer members of ASEAN should be strengthened so that they can take advantage of integrated regional markets while narrowing the income and other development gaps within ASEAN. East Asia and ASEAN has the largest disparity in terms of per capita income in PPP\$, as compared to other regional groupings such as Latin America, Europe, South Asia and North Africa. Studies had shown that large disparity in incomes and development will hinder efforts toward greater integration. Hence, concrete measures should be undertaken to address the increasing development gaps.

**Table 7. Summary Measures for Europe 34, East Asia 14, SEA 11 and other Regions**

|   | Mean  | CV    |
|---|-------|-------|
| Per Capita GDP (PPP\$) SEA 11   | 6937  | 113.1 |
| Per Capita GDP (PPP\$) East Asia 14   | 9090  | 101.9 |
| Per Capita GDP (PPP\$) Europe 34  | 18286 | 71.3  |
| Per Capita GDP (PPP\$) Accession-12   | 13491 | 29.7  |
| Per Capita GDP (PPP\$) South Asia   | 2321  | 37.3  |
| Per Capita GDP (PPP\$) North Africa   | 5306  | 30.0  |
| Per Capita GDP (PPP\$) Latin America  | 8223  | 32.0  |
| Notes:  |       |       |
| 1) CV is the coefficient of variation. The higher the measure, the higher the disparity   |       |       |
| 2) SEA 11 are the ASEAN member countries plus Timor L'este. The East Asia 14 are the SEA 11 plus Japan, Korea and China. 2002 value was used for Myanmar.                                   |       |       |
| 3) Europe 34 is composed of the 15 EU member countries and the 12 Accession countries and the so-called CIS-7 (Armenia, Azerbaijan, Georgia, Kyrgystan, Moldova, Tajikistan and Uzbekistan) |       |       |
| 4) South Asia covers India, Pakistan, Nepal, Bangladesh, Sri Lanka, Bhutan and Maldives   |       |       |
| 5) The North African countries are Algeria, Egypt, Morocco and Tunisia  |       |       |
| 6) The Latin American countries included are Argentina, Brazil, Chile, Mexico   |       |       |
| Source: Balboa, Medalla and Yap:2007 Basic data from 2005 UNDP Human Development Report   |       |       |

Cultivating economic and political relationships with the United States, and eventually the European Union, are also critical for the East Asian region. It is in this regard that APEC continues to hold an important role in the East Asian region as it is thru APEC that East Asia can engage the United States directly in a dialogue. For developing economies in the region, APEC even holds a more important role as it is venue currently in place to tie up with North America on important economic and security issues. For the European Union, plans are underway for negotiating economic partnerships or “new age” FTAs with countries in East Asia, specifically South Korea, ASEAN and India. A solid East Asia-EU FTA is seen as a possibility once Japan and China enter into the discussion.

## **VII. Conclusion**

It is clear that the economic landscape of East Asia has changed remarkably in the past decade. The economic center of gravity—that is production, trade and finance, had also changed direction so many times, and is now centred in Northeast Asia with the rise of China. Regionalism has risen sharply in the form of Free Trade Agreements, with new agreements still being negotiated between two or more countries. (World Bank, 2007)

After successfully integrating in the global economy and establishing itself as an economic bloc to reckon, East Asia is now in the process of integrating regionally. This is in large part a result of the lesson of the Financial Crisis of 1997 when East Asian countries learned the importance of strengthening economic ties and relying more on its neighbours in times of crisis. Added to this, integration has become a necessary response in the face of increasing competition among countries for market share.

The existing institutions in East Asia carry on the task of supplementing growth achieved during the market-led integration of the past decades, and more importantly, to support the development goals of the region. As new issues arise critical to the growth and fortitude of the economies, ranging from food and energy crisis, to demographic issues (in the case of the poorer countries in East Asia, the high population growth, and in the case of Japan and China, the ageing population), to natural disasters and calamities, and others, these institutions would bear the gargantuan task of keeping East Asia buoyant and capable of sustaining the growth achieved in the past decade. As an economically diverse region, the tasks that lie ahead for these institutions are not easy since they have to contend with not just pressing economic issues, but also the growing domestic friction brought about by the rising inequality, corruption and weak governance, environmental strains, rising urban squalor and other problems that threaten social cohesion. East Asia's regional architecture is evolving amidst the complex political-economic dynamics of the region. The biggest challenge yet is how to bring home the fruits of economic success of the region to individual economies in East Asia.

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