The Impact of Economic Development of East Asia, Including China, on Japan

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Abstract

The objective of this study is to assess the potential impact of the economic development of the East Asian countries, including China, on Japan. It is shown that (1) The contribution of the rest of East Asia to total GDP relative to Japan has increased significantly over time; (2) Japan remains the leading economy within East Asia in both aggregate and per capita terms; (3) Economic interdependence within East Asia due to trade and capital flows has been rising. It is argued that Japan is more complementary than competitive to the rest of East Asia, and potentially can benefit greatly from a free trade area/economic community that includes the developing economies of East Asia—China and the ASEAN without Singapore.

The impact of the economic development of East Asia, including China, on the Japanese economy is clearly positive. There is a "window of opportunity" for Japan to take a much more active leadership role in the promotion of region-wide East Asian economic cooperation and to shape the economic future of East Asia. The potential benefits of some form of East Asian economic cooperation are obviously huge. An appropriately structured East Asian free trade area/economic community may even provide an effective stimulus for renewed economic growth in Japan. It is Japan's choice whether it is to become East Asia's West Germany, or East Asia's United Kingdom.

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1. Introduction

The objective of this study is to assess the potential impact of the economic development of the East Asian countries, including China, on Japan. In this study, East Asian economies refer to the ASEAN + 3 (including the Chinese economic areas of Hong Kong, Macau and Taiwan). ASEAN is an acronym for the Association of Southeast Asian Nations, which currently includes Brunei, Indonesia, Khmer Republic (Cambodia), Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. The 3 are China, Japan and South Korea. In addition, there are the Chinese economic areas of Hong Kong, Macau and Taiwan.

During the past two decades, major developments have occurred in East Asia. The first and foremost is the emergence of the Chinese economy, through its policies of opening to the world and reform, on the global markets, beginning in 1979 and culminating in its accession to the World Trade Organization in 2001. Because of its high domestic savings rate, high rate of investment in human capital, large domestic market and unlimited supply of surplus labor, the Chinese economy is expected to continue to grow at between 7 and 8 percent per annum for the next two decades. By 2020, China is projected to have a GDP that is comparable in magnitude to Japan. The second is the relative stagnation of the Japanese economy, by the current time for more than a decade, since the bursting of its property price bubble in the late 1980s and early 1990s. The third is the East Asian currency crisis of 1997-1998, which plunged almost all of the East Asian economies, with the exceptions of China and Japan, into serious recessions. While most of the affected economies, with the exception of Indonesia, have since fully recovered, the crisis drove home once more the potential vulnerability of the exchange rates of the currencies of the smaller East Asian economies to large-scale short-term capital flows.

The slowdown in the growth of the Japanese economy itself in the 1990s has had two major effects. First, while Japan was the engine of growth for many of the other East Asian economies in the 1980s, through its direct investment and its trading companies and by providing a market for the exports of these economies, it was no longer able to play as important a role in the 1990s. As a result, many of the other East Asian economies had to develop new export markets and seek new foreign direct investors. Second, because of the Japanese slowdown, the non-Japanese portion of the East Asian GDP has grown much faster, so that by 2002, Japan's share of East Asian GDP has declined from more than 80 percent in 1960 to approximately 60 percent—still dominant, but no longer as dominant as before[1]. The other East Asian economies, including China, now have a much greater weight in terms of GDP, and because of their higher rates of growth, which result in higher demands for capital goods, can actually be a significant source of aggregate demand and hence economic growth for Japan. Looking ahead, the expectation is that Japan's share of East Asian GDP will continue to decline.

In Section 2, the evolution of the levels and rates of growth of the real GDPs of the East Asian economies is reviewed. In Section 3, the empirical evidence for the greater economic interdependence within East Asia is examined. In Section 4, the question of complementarity or competition between Japan and the other East Asian economies is considered. In Section 5, the possibilities of an East Asian Free Trade Area/Economic Community are assessed. Finally, brief concluding remarks on the potential leadership role of Japan in any initiative for region-wide economic cooperation in East Asia are made in Section 6.

2. Real GDPs and Real GDPs per Capita in East Asian Economies

In 1960, the GDP of the ASEAN + 3 was approximately 40 percent of the then U. S. GDP, with Japan contributing more than 80 percent of total East Asian GDP, followed by China (Mainland only), with not quite 8 percent. In 2000, the GDP of the ASEAN + 3 was approximately 75 percent of the then US

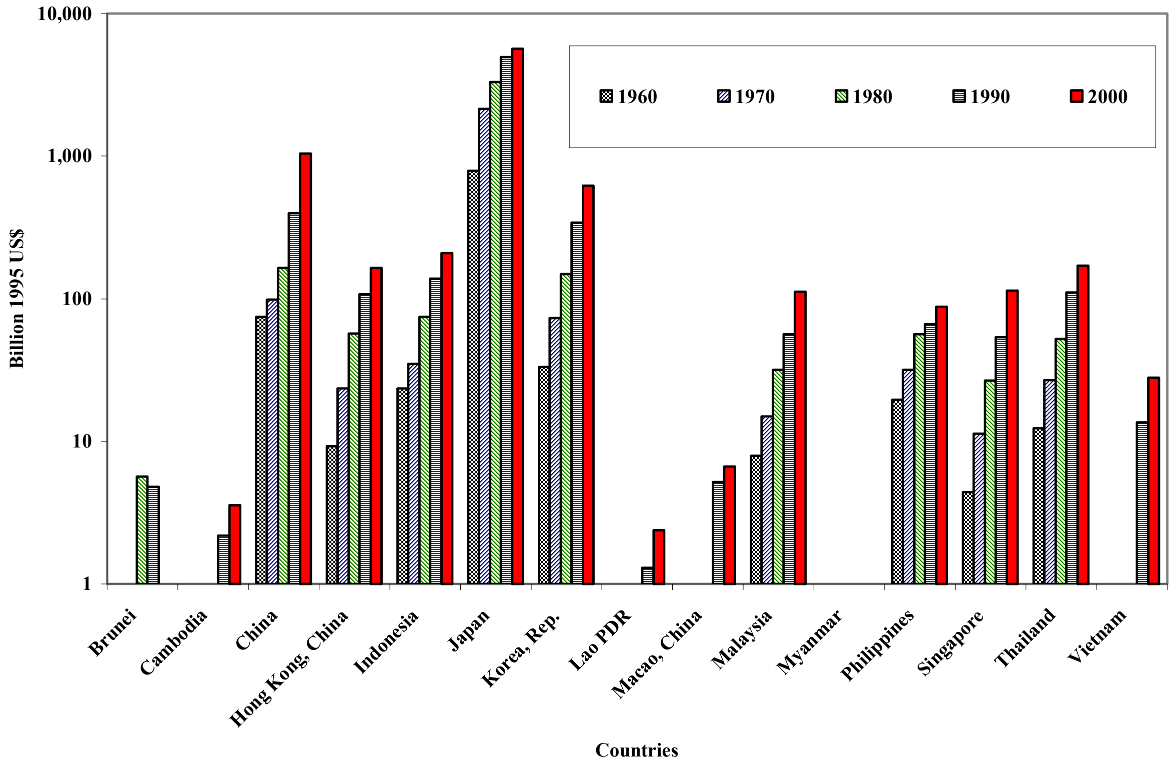
[1] If it were not for the East Asian currency crisis of 1997-1998, the exchange rates of the other East Asian economies would not have devalued by as much, and the Japanese share of East Asian GDP would have been lower.

GDP, with Japan contributing more than 60 percent of the total, followed by China (Mainland only), which contributed somewhat more than 15 percent. South Korea, and Hong Kong, Macau and Taiwan combined, each contributed between 5 and 10 percent. Thus, the ASEAN + 3 is also comparable to the Zone Euro in terms of the order of magnitude of its GDP. Despite the sluggish economic growth of the 1990s, the GDP of Japan is still larger than the GDP of all the other East Asian economies combined.

In Figure 2.1, the levels of the real GDPs of the East Asian economies, in 1995 U.S. Dollars, for each of the five decennial years of 1960, 1970, 1980, 1990 and 2000, are presented. It is clear that Japan still has by far the largest GDP among East Asian economies. However, it is also clear that the other East Asian economies have made great strides, especially during the two decades between 1980 and 2000, led by China and the East Asian newly industrialized economies (NIEs) of South Korea, Taiwan (not shown in Figure 2.1), Hong Kong and Singapore. But the gap between Japan and the other East Asian economies remains large. For example, despite the rapid economic growth of China over the past two decades, Chinese GDP in 2000 was still below the Japanese GDP in 1970.

In Figure 2.2, the levels of the real GDPs per capita of the East Asian economies, in 2000 U.S. Dollars, for each of the five decennial years of 1960, 1970, 1980, 1990 and 2000, are presented. It is clear that Japan also leads in real 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, GDP per capita in Mainland China was less than US$900 in 2000. But it is also clear that the gap in real GDP per capita between Japan and the East Asian newly industrialized economies has been closing. Hong Kong, Macau, South Korea and Taiwan (not shown in Figure 2.2) all have real GDPs per capita that significantly exceed US$10,000 in 2000.

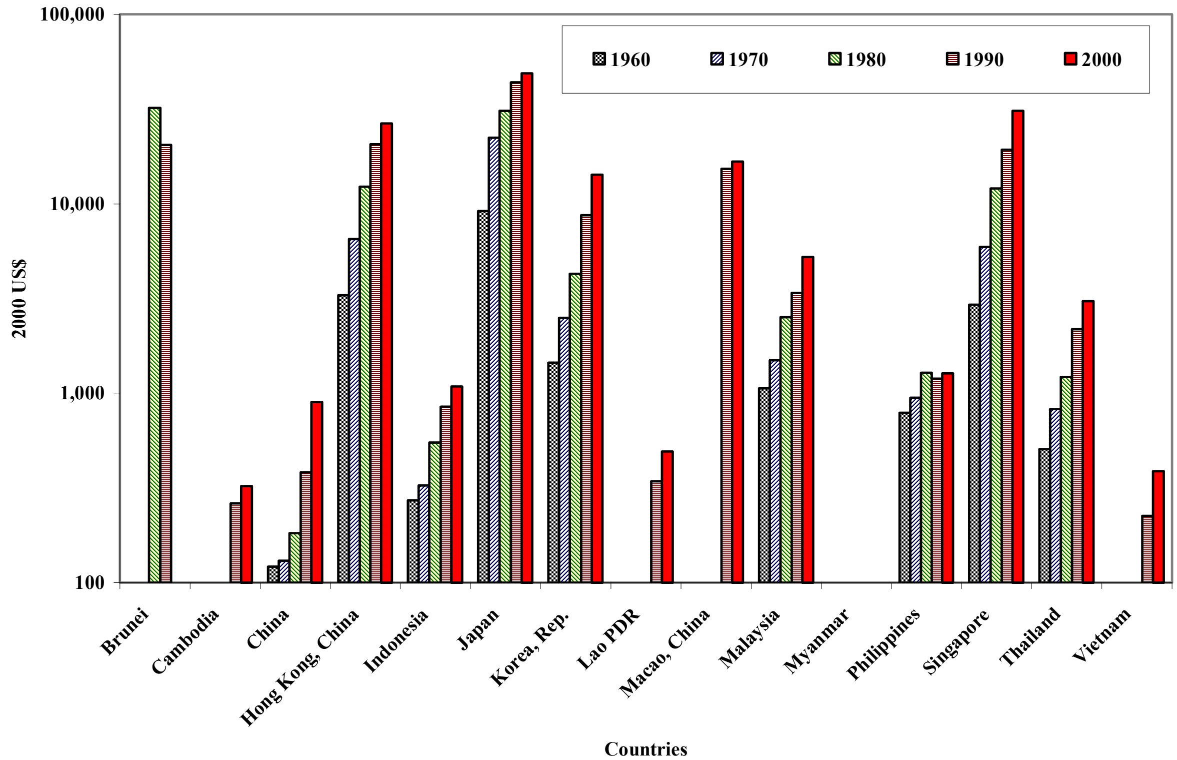
Figure 2.1: Real GDP of East Asian Economies, Billion 1995 US$



These figures and percentages for real GDPs and real GDPs per capita 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 over time and (2) Japan remains the leading economy within East Asia in both aggregate and per capita terms, are inescapable.

In Figure 2.3, the average annual rates of growth of real GDPs of East Asian economies by decades are presented. 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 in 1973 and 1980 respectively, the average annual rates of growth in the two subsequent decades declined significantly to less than 5 percent. And since 1990 the average annual rate of growth in Japan has been below 2 percent.

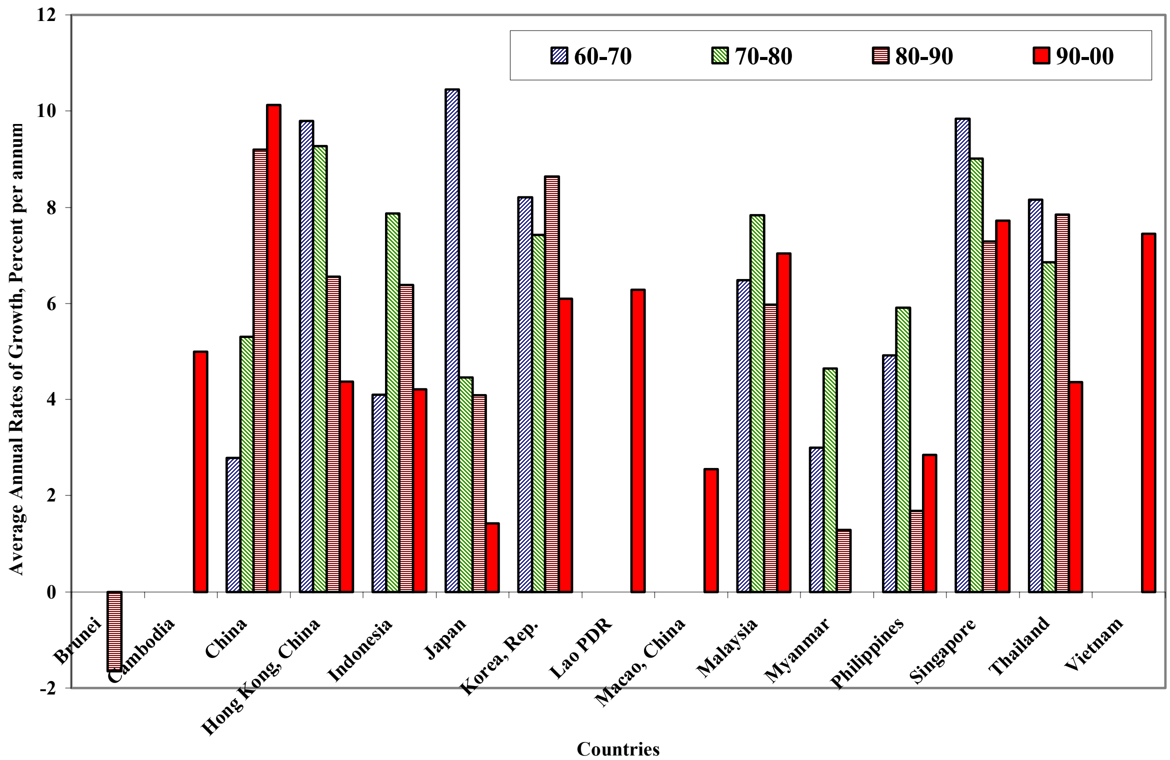
Figure 2.2: Real GDP per Capita of East Asian Economies, 2000 US$



In contrast, the rest of East Asia, with the exceptions of Brunei, Macau, Myanmar and the Philippines, have been able to grow significantly faster than Japan in the decades of the 1980s and 1990s, despite the considerable slowdown in the Japanese economy during the past decade. In particular, China was able to achieve an average annual rate of growth of almost 10 percent over the past two decades, a performance comparable to that of Japan between 1955 and 1972. Notwithstanding the East Asian currency crisis of 1997-1998, the other East Asian economies, with the aforementioned exceptions, were still able to achieve respectable average annual rates of growth ranging between 4 percent and 8 percent during the decade of the 1990s, significantly higher than that of Japan. Japan has the dubious distinction of being the East Asian economy with the lowest average annual rates of growth in the decade of the 1990s, at least among those economies for which data are available. For the decade of the 1980s, the real rate of growth of the Japanese economy was higher than only Myanmar and the Philippines among the East Asian economies.

Even for the decade of the 1970s, the real rate of growth of the Japanese economy was the lowest among those East Asian economies for which data are available.

Figure 2.3: Rates of Growth of Real GDP, East Asian Economies, Selected Periods



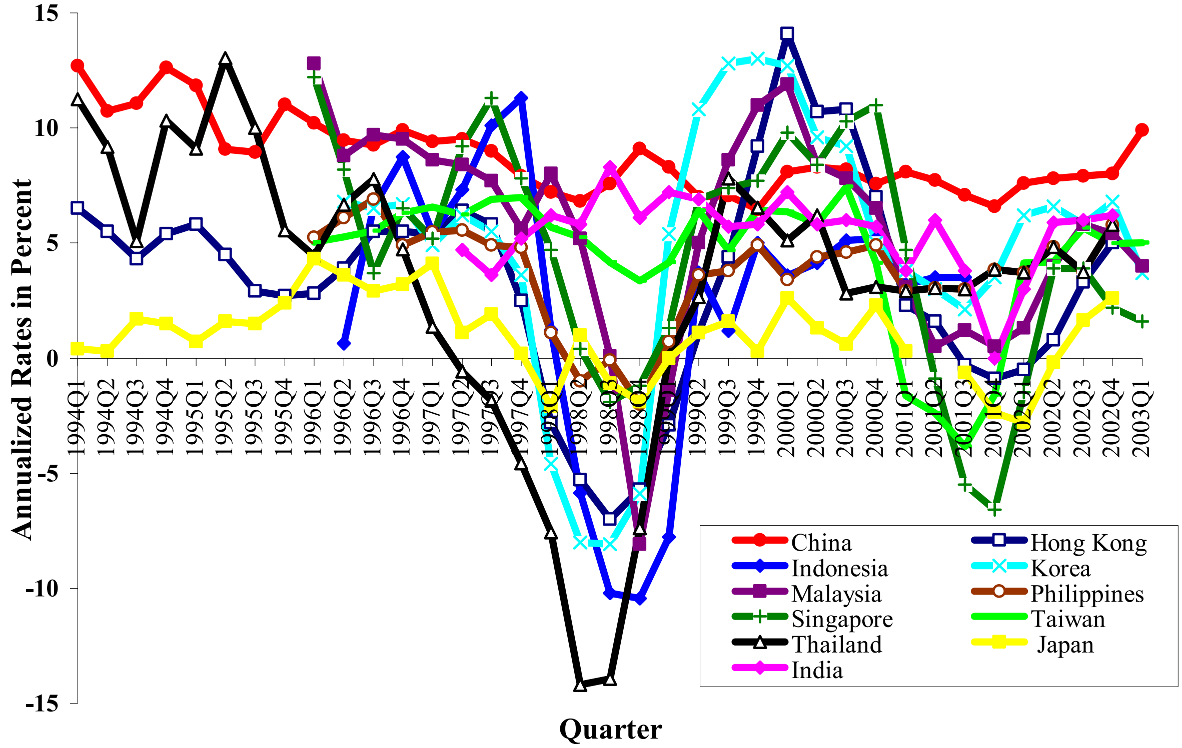
3. Rising East Asian Economic Interdependence from Trade and Capital Flows

Over the past two decades, the East Asian economies have also greatly increased their trade with one another (and with China in particular). The shares of exports of East Asian economies destined for other East Asian economies have been increasing rapidly. The share of Japanese exports destined for other East Asian economies has risen to 40 percent in 2001. Similarly, the share of East Asian exports in Japanese imports has also risen to 40 percent in 2001. By the late 1990s, approximately 50 percent 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 in East Asia.

Because of the possibility of synchronization of economic cycles as, for example, during the East Asian currency crisis, 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.

In Figure 3.1, the quarterly year-on-year rates of growth of real GDPs of selected East Asian economies are presented. Figure 3.1 clearly demonstrates the extraordinary steepness of both the economic downturns and recoveries that may result from a synchronized external shock, in this case, the East Asian currency crisis of 1997-1998. Two East Asian economies, China and Japan, were largely immune from the East Asian currency crisis. China held steady with a real rate of growth between 7 and 8 percent from the mid-1990s onwards, and Japan had a real rate of growth fluctuating between 0 and 2 percent during the decade of the 1990s. The immunity followed largely from the relative small shares of exports as a percent of the GDPs of China and Japan.

Figure 3.1: Quarterly Rates of Growth of Real GDP, Year-over-Year, Selected East Asian Economies



In Figures 3.2 and 3.3, the quarterly year-on-year rates of growth of exports and imports of selected East Asian economies are presented. Once again, the highly synchronized nature of the changes in the rates of growth of exports and imports is apparent. The rates of growth of even the Chinese and Japanese exports and imports fluctuated like all the other East Asian economies, even though the fluctuations did not carry over to their rates of growth of real GDP. Once again, it is the steepness of the decline and rise of the rates of growth of exports and imports that indicates a significant degree of economic interdependence among the East Asian economies.

Figure 3.2: Year-over-Year Quarterly Rates of Growth of Exports in U.S.$ (Percent)

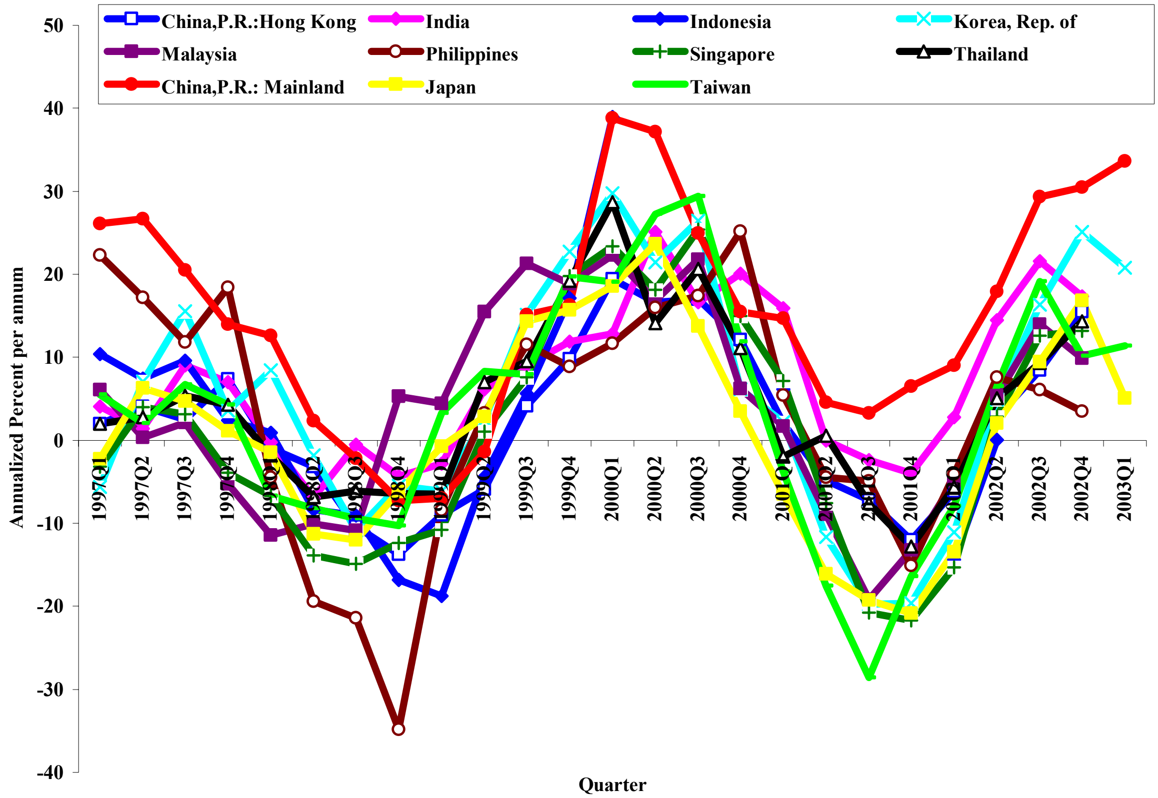
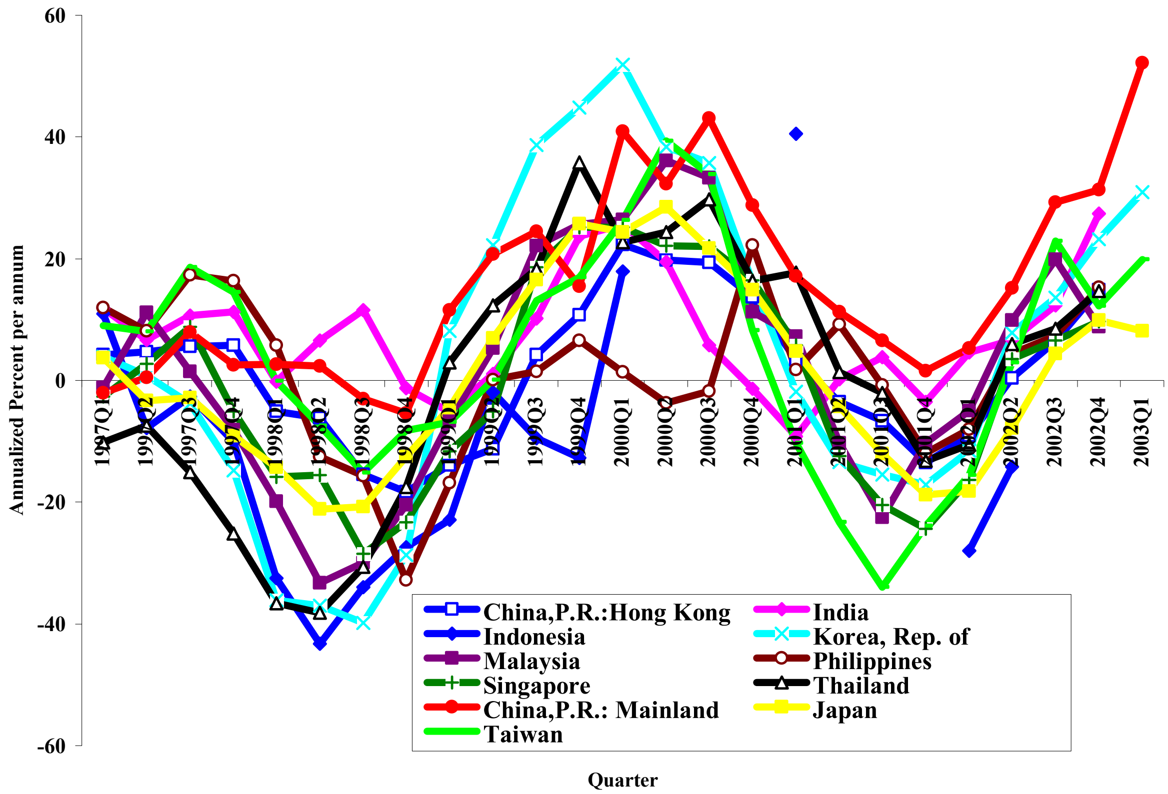


Figure 3.3: Year-over-Year Quarterly Rates of Growth of Imports in U.S.$ (Percent)



In Table 3.1, the shares of the exports of selected East Asian countries and regions destined for other East Asian economies in 1980, 1990 and 2001 are presented. It is clear that between 1980 and 2001, the shares of exports from Japan, China, Hong Kong, Taiwan, South Korea and the ASEAN to other East Asian economies have all risen, to a range between 40 and 63 percent. The emergence of the Chinese economy on the global market was an important new development during the past two decades. The share of Chinese exports destined for other East Asian economies has increased from 36 percent in 1980 to 58 percent in 2001. Trade between China and Japan reached US$101.9 billion in 2002 (exports of US$48.4 billion and imports of US$53.5 billion). Japan has been China's largest trading partner for ten years and China recently became Japan's largest source of imports, in 2002.

Table 3.1: Shares of Exports to East Asia

	Japan	China	Hong Kong	Taiwan	S. Korea	ASEAN	U.S.	E.U.	R.O.W.	Total
1980	**0.22**	**0.36**	**0.62**	**0.30**	**0.31**	**0.47**	**0.23**	**0.05**	**0.16**	**0.14**
1990	**0.26**	**0.54**	**0.72**	**0.42**	**0.35**	**0.51**	**0.36**	**0.08**	**0.16**	**0.20**
2001	**0.40**	**0.58**	**0.63**	**0.53**	**0.42**	**0.62**	**0.30**	**0.10**	**0.14**	**0.24**

In Table 3.2, the ranks of China, Japan and the U.S. as destinations for the exports of East Asian economies in 1980, 1990, 2000 and 2001 are presented. Over time, China has become an increasingly important destination for the exports of other East Asian economies, as witnessed by the rising ranks of China as an export destination between 1980 and 2001 (and in particular over the one-year period between 2000 and 2001). Southeast Asian exports to China have continued to grow by leaps and bounds in 2002 and in the first quarter of 2003. However, Japan remains, for the time being, 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 export destination for South Korea). The U.S. has also remained the most important export destination for most of the East Asian economies, including China, Japan, South Korea and Taiwan.

Table 3.2: Ranks of China, Japan and the U.S. as Destinations of East Asian and U.S. Exports

	China Export Rank				Japan Export Rank				U.S. Export Rank			
	1980	1990	2000	2001	1980	1990	2000	2001	1980	1990	2000	2001
Japan	5	12	4	2					1	1	1	1
U.S.	17	18	11	9	2	2	3	3				
China					2	2	3	3	3	3	1	1
Hong Kong	4	1	1	1	5	4	3	3	1	2	2	2
S. Korea	N/A	31	3	2	2	2	2	3	1	1	1	1
Taiwan	N/A	183	8	4	2	3	3	3	1	1	1	1
Brunei	N/A	10	8	7	1	1	1	1	2	7	4	3
Cambodia	N/A	13	5	8	3	4	6	4	N/A	N/A	1	1
Indonesia	64	6	6	5	1	1	1	1	2	2	2	2
Laos	N/A	2	11	11	N/A	3	6	10	N/A	20	9	13
Malaysia	13	11	10	7	1	3	3	3	3	2	1	1
Myanmar	17	4	4	4	2	5	5	7	26	9	1	2
Phillippines	19	17	12	12	2	2	2	2	1	1	1	1
Singapore	14	14	6	5	3	3	4	4	2	1	2	2
Thailand	13	19	6	5	1	2	2	2	3	1	1	1
Vietnam	N/A	22	2	5	N/A	2	1	1	N/A	50	5	3

In Table 3.3, the shares of the imports of selected East Asian countries and regions originating from other East Asian economies in 1980, 1990 and 2001 are presented. It is also clear that between 1980 and 2001, the shares of imports in Japan, Hong Kong, Taiwan, South Korea and the ASEAN from other East Asian economies have all risen, to a range between 40 and 56 percent. The only East Asian country in which the import share from other East Asian economies has declined is China; but even then the East Asian share of Chinese imports in 2001 was a high 48 percent.

Table 3.3: Shares of Imports from East Asia

	Japan	China	Hong Kong	Taiwan	S. Korea	ASEAN	U.S.	E.U.	R.O.W.	Total
1980	0.26	0.53	0.25	0.20	0.30	0.53	0.22	0.03	0.18	0.15
1990	0.30	0.65	0.42	0.34	0.34	0.51	0.27	0.06	0.21	0.19
2001	0.40	0.48	0.51	0.51	0.45	0.56	0.24	0.07	0.17	0.22

In Table 3.4, the import ranks of East Asian economies in China, Japan and the U.S. respectively in 1980, 1990, 2000 and 2001 are presented. The ranks of almost all East Asian economies in the imports of both China and Japan have also been rising (that is, becoming higher in rank and lower in number) over time, with the exception of Laos and Myanmar. For example, South Korea went from being the 27th most important source of Chinese imports in 1990 to the third most important in 2001. It also went from the 13th most important source of Japanese imports in 1980 to the third most important in 2001. China went from being the 8th most important source of Japanese imports in 1980 to the second most important in 2001 (and the most important in 2002). It also went from being the 36th most important source of U.S. imports in 1980 to the fourth most important in 2001. In contrast, Both Hong Kong and Taiwan have declined in their importance in U.S. imports, one reason being the relocation of the final finishing process in the manufacturing of many goods from Hong Kong and Taiwan to Mainland China.

Table 3.4: Ranks of East Asian Economies and the U.S. as Origins of Imports of China, Japan and the U.S.

	China Import Rank				Japan Import Rank				U.S. Import Rank			
	1980	1990	2000	2001	1980	1990	2000	2001	1980	1990	2000	2001
Japan	1	2	1	1					2	2	3	3
U.S.	2	3	3	2	1	1	1	1				
China					8	4	2	2	36	9	4	4
Hong Kong	6	1	5	5	32	20	36	37	14	13	21	24
S. Korea	N/A	26	2	3	13	5	3	3	16	8	7	8
Taiwan	N/A	N/A	12	10	15	10	4	8	10	5	8	9
Brunei	N/A	80	75	61	12	32	37	35	70	86	81	80
Cambodia	N/A	104	76	86	135	132	84	75	N/A	N/A	65	65
Indonesia	55	13	10	16	3	2	5	4	13	24	21	20
Laos	N/A	72	109	111	120	126	125	138	141	164	156	170
Malaysia	14	11	7	7	10	12	8	7	23	19	11	11
Myanmar	N/A	39	59	63	63	87	69	69	126	118	75	74
Phillippines	38	40	23	24	16	22	13	13	29	25	18	19
Singapore	16	12	8	9	22	17	15	18	28	12	12	15
Thailand	23	17	11	12	24	15	11	11	39	17	14	14
Vietnam	N/A	94	33	33	73	41	28	25	N/A	N/A	67	62

Sufficient evidence has been presented to support a picture of the increasing relative importance of the trade flows within East Asia itself over time and the emergence of China as an important trading country in East Asia. In contrast, the share of U.S. exports destined to East Asian economies as well as the share of U.S. imports originated from East Asian economies have both declined slightly during the last decade. If the East Asian economies continue their current growth trajectories and/or any of the proposed free trade areas—the ASEAN Free Trade Area (AFTA), the China + ASEAN Free Trade Area, or the ASEAN + 3 Free Trade Area—were to come to realization, the intra-East Asian trade is likely to become even more important in the future.

In addition to the growing importance of intra-East Asian trade flows over the past two decades, intra-Asian capital flows and technology transfers have also become increasingly frequent and important. We may recall the "wild geese flying" pattern of East Asian industrialization, so aptly described by Kaname Akamatsu (1962). Japan was the first East Asian country to become industrialized. Because of currency appreciation, rising real wage rates, and the imposition of export quotas by other developed economies, manufacturing with lower-skill requirements began to be relocated from Japan to first Hong Kong, then Taiwan, then South Korea, and then Southeast Asia and now Mainland China. In this process, vast trade flows have been created, not only in terms of the final finished goods, but also in terms of the intermediate goods and capital goods.

Japan was also the first East Asian country to become a major direct investor in other East Asian countries, aided by its ubiquitous trading firms. Beginning in the 1980s, other East Asian economies, such as Hong Kong, Singapore, South Korea and Taiwan, facing the same economic pressures as Japan, have also become major direct investors in the East Asian developing economies, including, in particular, China. More recently, Chinese enterprises have also begun to make direct investments abroad. Much of the expansion in intra-East Asian trade has been caused, in part, by the direct investment flows. For example, the bulk of the growth in Chinese exports over the past two decades is attributable to foreign-invested enterprises in China.

4. 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). (In terms of real GDP per capita, Hong Kong and Singapore may also be considered to be developed economies. However, because of their relatively small size, they lack the industrial and technological capability that is normally associated with a developed economy. South Korea and Taiwan, with lower real GDPs per capita, are actually potentially more comparable to Japan.) 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. Moreover, what Japan exports is typically not even produced in other East Asian developing economies. Japan is still the premiere and only source of advanced capital goods and technology within East Asia, and faces little competition from within East Asia itself. What China and the ASEAN without Singapore export, Japan has not exported for decades, even though it may still produce such goods for domestic consumption under the protection of mostly non-tariff trade barriers. This complementarity is borne out by the trade statistics at the disaggregated commodity level. The East Asian newly industrialized economies (NIEs) of Hong Kong, South Korea, Singapore and Taiwan, especially South Korea and Taiwan, are actually more 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, a large part of Japanese exports consists of intra-industry and intra-firm trade, which reflects the fact that these exports are mostly based on long-term supplier-user relationships and/or direct investment made by Japanese parent firms. The increasing globalization of supply chains and the concomitant de-verticalization of production and outsourcing have accounted for much of the expansion of intra-industry and intra-firm trade.

It is evident that the largest potential gain from the establishment of a free trade area results if the economies involved are complementary rather than competitive. Thus, the largest potential gain that may accrue to Japan's participation in any free trade area is a China-Japan-the ASEAN free trade area rather than a Japan-South Korea-Singapore-Taiwan combination. The demands for capital goods and technology are enormous in China and the ASEAN for as far as the eyes can see and Japan is well positioned to be the premiere supplier. In return, Japan can import light-manufactured consumer goods from the East Asian developing economies. Such a specialization, based on comparative advantage, makes the most sense in the East Asian context. Japan will be able to capitalize on its unique strengths in the manufacture of capital goods, including complex manufacturing production lines, and its industrial R&D capability, especially in process technologies. The continued rapid economic development and growth of East Asian economies, including China, therefore present huge unprecedented opportunities for Japan.

5. The Possibilities of an East Asian Free Trade Area/Economic Community

An ASEAN + 3 Free Trade Area bears a superficial resemblance to the "Great East Asia Co-Prosperity Sphere" and may be regarded as a voluntary and co-operative version of the same. The economic logic for such a free trade area is unexceptionable. However, it must be approached with care and forethought. Several principles are important. First, there should be a separation of economics and politics, at least initially. Politics is usually the more difficult part; by keeping it out, the probability of success is enhanced. Second, there should be dual leadership, by both China and Japan. This is simply a recognition of the economic realities of today. An East Asian Free Trade Area without the participation of both China and Japan is unlikely to be successful; just as close Franco-German cooperation in the early efforts to establish the European Common Market was indispensable. Third, there should be universal inclusivity—all East Asian economies that are willing to abide by the rules should be allowed to join.

Reduction and Elimination of Tariff and Non-Tariff Trade Barriers in East Asia

Free trade per se is likely to rouse domestic opposition almost everywhere in East Asia, except possibly in Hong Kong and Singapore. In principle, the gains from free trade should outweigh the losses, and the losers can be adequately compensated; in practice, it is difficult to tax the winners and to use the proceeds to compensate the losers. World Trade Organization membership is almost universal among the East Asian economies. Free trade can be promoted on the grounds that it increases the size of the regional market which in turn attracts foreign direct investors that otherwise may not come. Free trade can also be more easily promoted on comparative advantage grounds if there is an adequate mechanism for compensating the most important group of losers, the displaced workers.

One such mechanism is the use of public funds to compensate displaced workers in all affected countries. For example, under any trade liberalization mandated by a free trade area, increased Japanese exports of capital goods may displace workers in some East Asian developing economies whereas increased Japanese imports of light-manufactured and agricultural consumer goods may displace Japanese workers. Compensation for displaced workers can be paid monthly for a fixed period, say, ten years, through an industry-specific fund financed with tariffs at pre-existing rates, or by equivalent tariffs corresponding to pre-existing quotas on above-quota imports, for all displaced workers above a certain age, say, 50. Such tariffs will be phased out completely when the value of the fund is equal to the present value of the future liabilities to the displaced workers. Displaced workers younger than 50 will be retrained at government expense (retraining expenses can also be paid from the fund). Older displaced workers will be encouraged to retire. Since the number of displaced workers is fixed, the cost of such compensation is also fixed and finite and will eventually be covered by tariff collections. The basic idea here is to continue the tariffs for a while in order to build up the compensation fund but the inefficient domestic production will be phased out immediately. All the tariffs collected will go to compensate the displaced workers.[2]

[2] Of course, many variations of the mechanism are possible. One can also have the pre-existing tariff rates be reduced by 50%, so that everyone, displaced workers and consumers, can benefit. The objective is to have a transitional phase that creates as few losers as possible.

Coordination and Stabilization of Intra-East Asian Exchange Rates

With increasing economic interdependence in East Asia, and particularly if a free trade area is established, the coordination and stabilization of relative parities among East Asian currencies become important. It should be emphasized that the objective is to stabilize the relative parities among East Asian currencies and not necessarily the absolute parities between East Asian currencies and, for example, the U.S. Dollar. Competitive relative devaluation among East Asian currencies can lead to great instability, especially in the context of a free trade area, both for the individual economies and for the region as a whole (as well as globally). Predictability and stability of the relative exchange rates over the medium to long term facilitate international division of labor and direct investment flows and can enhance economic growth within East Asia. It is therefore important to try to maintain relative parities of the exchange rates among the East Asian developing economies, other things being equal. Exchange rate policy coordination among East Asian economies can help to prevent/minimize contagion that may result from unexpected and unintended changes in the relative exchange rate alignments, and hence forestall a vicious cycle of competitive devaluation. Very often timely intervention can make a significant difference for all by preventing over-shooting adjustments in the currency markets with their irreversible negative effects. (For example, timely intervention in the currency market of Indonesia in 1997 might have prevented the Rupiah from sinking to 17,500 Rupiah per U.S. Dollar and thus helped to reduce the misery there significantly.[3])

The ASEAN + 3 have approved, in principle, bilateral standby swap arrangements for the support of the exchange rates of individual currencies. It is also possible to have bilateral agreements on settlement of transactions in the currencies of the respective countries instead of the U.S. Dollar (up to a maximum ceiling amount if necessary), thus conserving foreign exchange reserves and freeing them up for potential use in emergencies. Currently the bulk of the intra-East Asian trade is denominated in U.S. Dollars. With the formation of a free trade area, intra-East Asian trade can begin to be denominated in one or more East Asian

[3] In retrospect, the proposal for an East Asian Currency Stabilization Fund put forward by the Government of Japan in the summer of 1997 was an excellent idea. Unfortunately it was opposed by the International Monetary Fund and was never implemented.

currencies on a purely voluntary basis. The same result can also be achieved through an East Asia-wide multilateral agreement. For example, it is possible to envision a Bank for Intra-Asian Settlements along the same lines as the Bank for International Settlements (BIS) in the early post-World War II period to do for East Asia what BIS did for Europe, i.e., to facilitate settlement of balance of payments in the individual currencies.

A regional cooperative currency stabilization fund may also have a useful role to play in East Asia as a lender of foreign exchange of last resort by augmenting the potential foreign exchange reserves perceived to be available for the defense of any single currency against speculation, in both directions. One thing that East Asian economies have in great abundance is official foreign exchange reserves. Japan has the world's largest official foreign exchange reserves, in excess of US$600 billion. China has official foreign exchange reserves in excess of US$300 billion. Hong Kong, South Korea, Singapore and Taiwan have approximately US$100 billion worth of official foreign exchange reserves each. Indonesia, Malaysia, the Philippines and Thailand have all rebuilt their official foreign exchange reserves to varying degrees. A conservative estimate is that close to US$1,500 billion worth of foreign exchange reserves may be potentially available to the East Asian central banks collectively. They can be put to good use when needed.

However, in order to avoid moral hazard, individual countries must meet certain prescribed rules of liquidity and solvency in order to avail themselves of the collective currency stabilization fund. One must carefully distinguish between liquidity problems, which are soluble with sufficient foreign exchange reserves, from solvency problems which cannot be solved with foreign exchange reserves alone. Moreover, the fund should be dedicated to the stabilization of exchange rates only and cannot and should not be used for other purposes, such as making up the current budget deficit of a country. Often, the mere existence of such a region-wide currency stabilization fund is sufficient to discourage speculation in the currencies of smaller East Asian economies and help stabilize their exchange rates.

Is there room for a common East Asian currency in the future? If there is ever an East Asian currency, it will most likely begin with a system of stable relative parities among the different East Asian currencies similar to the "snake" of the former European Monetary System (EMS), especially among the smaller East Asian developing economies. If the Japanese Yen is to be an integral part of such an East Asian snake, the volatility of the Yen/US$ exchange rate must be significantly reduced in order for the snake to be viable in the long run. However, it is possible for the snake to include only the currencies of the East Asian developing economies initially. Even though capital controls still exist in China, the Yuan/US$ exchange rate is also critical to the stability of the exchange rates of other East Asian currencies. (Recall that by holding fast to the exchange rate and not devaluing the Renminbi during the East Asian currency crisis, China contributed greatly to the speedy recovery of the other East Asian economies.) A common East Asian currency will most likely be based on a relatively stable parity between the Yen and the Yuan. Cooperation between China and Japan is therefore absolutely essential for the emergence of a common East Asian currency.

Harmonization of Standards and Facilitation of Exchangeability

Harmonization of standards is a pre-requisite to increased trade. They include technological standards—for example, mobile telephones[4], television, data transmission, financial data protocols and software standards—as well as rules, regulations and taxation policies for cross-border economic activities, e.g., e-commerce. Uniform region-wide standards for the grading, inspection, testing and certification of commodities and products should be established so as to facilitate trade.

Coordination of Foreign Direct Investment Policies

With the establishment of a free trade area, and particularly if coupled with stable relative parities of the exchange rates, the location decision of a direct investment can be made mostly on the basis of efficiency considerations. The objective of the coordination of foreign direct investment policies is two-fold: first, is to

[4] Japan and South Korea are two of the few countries in the world where visitors cannot use their cell phones even with tri-band handsets, because of local incompatibilities, even though they can use their cell phones worldwide otherwise.

facilitate the cross-border flow of investment within East Asia; and second, to prevent ruinous competition for foreign investment among the East Asian economies. One of the potential benefits for a developing economy to participate in a free trade area along with other developing economies is the possibility of attracting foreign direct investment because of the expanded market. Thus, in order to realize these benefits, one must adopt laws and rules and regulations that are foreign direct investment-friendly. These will include the protection of foreign investment from confiscation and nationalization, the right to repatriate principal and profits, the conclusion of tax treaties that provide for the elimination of double taxation of foreign direct investors as well as the exchange of tax information with the tax authorities of the home countries of the foreign direct investors. Export requirements on foreign direct investment should be eliminated. And there should be a common policy for the free movement of employees of foreign direct investors (on residence, tax, pension and other related matters). Region-wide there should be a harmonization of investment benefits for foreign direct investors in terms of tax and other concessions so as to prevent ruinous competition (differentiation by host countries may be permitted on the basis of real GDP per capita).

Coordination of Capital Market Policies

The objective of coordination of capital market policies is also two-fold: first, to facilitate the flow of portfolio investment region-wide; and second, to prevent gaming by corporations and investors for trying to exploit the most lightly supervised and regulated capital market in the region. There should be harmonization of accounting standards, disclosure and transparency requirements, margin requirements, and rules and regulations governing market manipulation and insider trading. The goal is to standardize regulation, rationalize listing requirements and to facilitate reciprocal listing in markets region-wide. Ultimately, perhaps a region-wide stock and bonds exchange, with significantly enhanced liquidity, will emerge.

Common Issues on World Trade

If an East Asian Free Trade Area is to come about, the members should coordinate and harmonize their positions on certain common issues in world trade. For example, the existing rules of origin are extremely unwieldy and completely incompatible with the trend of globalization of supply chains through de-verticalization (fragmentation) and out-outsourcing. An East Asian Free Trade Area should take the initiatives to abolish such rules within East Asia, and to advocate their replacement by basically anti-surge or safeguard provisions that are temporary and transitional in nature. Dumping and anti-dumping rules are also ready for a thorough revamping. Labor and environmental standards, including carbon dioxide emissions, ought to be carefully considered, taking into account the stage of economic development of the individual countries (e.g., a region-wide trading mechanism for emissions is a possibility).

Within the framework of region-wide cooperation, it is possible to internalize many problems caused by externalities and thereby make feasible more efficient solutions. For example, acid rain is a problem for Japan, caused by the use of un-treated high-sulfur coal in China. The wind carries the sulfur dioxide from China to Japan, resulting in acid rain. The cost of mitigating the damages caused by acid rain, on property and on health, once it occurs, is very high. However, it is entirely possible for a Japanese firm to invest in coal-burning utilities in China, thus making sure that the coal used is pre-scrubbed. The acid rain problem can thereby be avoided and the added cost due to scrubbing is still much lower than the potential clean-up cost otherwise. There is therefore room for potentially a Pareto-improving win-win solution.

It is also possible to devise mechanisms for the internalization of adjustment costs. We have described above a mechanism for using tariffs to compensate displaced workers. One possible mechanism is based on the idea that in order for a manufacturer/exporter of equipment to increase its exports, additional imports of the products that the equipment is used to produce may be necessary. Thus, there is a trade-off between exports of capital equipment and imports of finished goods. For example, it is conceivable that a textile manufacturer in an East Asian developing economy may tell a Japanese manufacturer of textile machinery that it can only pay for the new equipment with new textile exports to Japan. The Japanese manufacturer will therefore need to balance its profit margin on the equipment with the tariff that it will have to pay on the textile imports[5].

6. Concluding Remarks

The impact of the economic development of East Asia, including China, on the Japanese economy is clearly positive. The share of Japanese exports destined for other East Asian economies has been rising rapidly. With the rapid economic growth in the other East Asian economies, it may be expected to rise even further. If the other East Asian economies had been stagnant, the Japanese economy would be in far worse shape than it is now. However, there is now a "window of opportunity" for Japan to take a much more active leadership role in the promotion of region-wide East Asian economic cooperation and to shape the economic future of East Asia. At this time, Japan on the one hand and China and the ASEAN on the other hand are economically complementary. The potential gains of cooperation and specialization are at a maximum. In another decade or two, this may no longer be the case.

An East Asian Free Trade Area/Economic Community will likely take decades to get off the ground. A historical precedent is provided by the evolution of the European Union, a process spanning more than half a century, beginning with the authorization of the Bank for International Settlements for the settlement of intra-European balance of payments. This was followed by the establishment of the European Coal and Steel Community, which was subsequently expanded to become the European Common Market, and then progressively the European Economic Community, and now the European Union and the Zone Euro. The support of the United States and the pressure of the common Soviet threat helped greatly to overcome the internal dissension within Europe. The leadership of far-sighted European statesmen who saw in an economic community the critical framework for the prevention of another intra-European war was also indispensable.

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[5] Part of the tariffs to be paid, now borne by the Japanese manufacturer of textile machinery, will come out of the profits made from the additional equipment sale.

Is there the political will in Japan, China, and the rest of East Asia 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 countries as a group ready to restrain nationalistic sentiments and support the rise of global or region-wide corporations by facilitating the free cross-border movements of long-term capital and direct investment? Can Japan, China, and the other East Asian countries put their historical enmity behind them and enter a new era of mutually beneficial cooperation? These are all very difficult, and some would say intractable, questions.

However, the potential benefits of some form of East Asian economic cooperation are also obviously huge. Japan, because of its economic and technological strength, can and should play a leading role. An appropriately structured East Asian Free Trade Area/Economic Community may even provide an effective stimulus for renewed economic growth in Japan. It is Japan’s choice whether it is to become East Asia’s West Germany, or East Asia’s United Kingdom.

References

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