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# **East Asian Economic Integration and Its Impact on China’s Economy**

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\* This paper only represents the author’s viewpoints, not necessarily the position of DRC and Renmin.

## Abstract

This paper reviews the current state of East Asian Economic Integration, i.e. AFTA, ASEAN+1, ASEAN+3, ASEAN+6, North-East Asia FTA, FTAAP, CMI, AMF, ABM, Asian Currency, etc., and further investigates its driving forces and impact on the Chinese economy.

Though China has greatly benefited from the integration into the rest of the world including the East Asia, its export-oriented growth model has also arisen serious imbalance problems and financial risks. To sustain its growth and avoid the 1990s recession in Japan, China needs to shift the export-oriented growth model to rebalance its payment. Evidences show that the economic integration with East Asia is good for solving China's problems.

# Outline

- **1.Introduction**
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  - 2.3 Challenges and Prospect
- **3. Its Impact on the Chinese Economy**
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- **4. Concluding Remarks**
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# 1.Introduction

- East Asia in the World:
  - — — Population: 2 billion, 31%
  - — — GDP: ASEAN+3
  - — — Trade:5 trillion US\$, 20%
  - — — official reserves: 2.6 trillion US\$, 50%
  - — — Negative Impact of Financial crisis in 1997
- One of the three economic poles in the World:
  - EA + NAFTA+EU

## 2. East Asian Economic Integration

- *2.1 Current State of Eco Integration (institutional initiatives)*
  - — — ASEAN-FTA
  - — — ASEAN + 1
  - — — ASEAN + 3
  - — — ASEAN + 6
  - — — Northeast China-Japan-Korea FTA
  - — — FTAAP: Free Trade Area of the Asia Pacific
  - — — Chiang Mai Initiatives.
  - — — Regional Policy Dialogue and Economic Surveillance
  - — — Asian Bond Market
  - — — AMF-Asian Monetary Fund
  - — — Single Currency

# ASEAN-FTA

- In 1992, the ASEAN member countries first proposed a free trade agreement. Since then, the member governments have been making strenuous efforts to remove import quotas and lower tariffs in their intra-ASEAN trade.
- by 2002: The advanced six members had reduced their tariffs to 0-5 percent
- by 2015: a tariff free area,
- by 2020: economic community— free movements of goods, people and capital (Kawai, 2005).

# ASEAN + 1

- — — **Japan**: implemented a bilateral economic partnership agreement (EPA) with Singapore in November 2002, and began negotiations with ASEAN in April 2005 on an EPA. Japan has almost concluded bilateral negotiations for EPAs with Malaysia, the Philippines and Thailand, is negotiating EPAs with Korea and Indonesia.
- — — **China**: began official negotiations with ASEAN to complete a free trade agreement (FTA) by 2010 with advanced ASEAN members, and by 2015 with less advanced members. They have already implemented the “early harvest” measures since January 2004 and made a FTA for goods trade effective in January 2005.
- — — **Korea**: has also begun a similar negotiation with ASEAN to be completed by 2009.
- China, Japan, and Korea are competitive for regional FTAs/EPAs with ASEAN. Recently, India and Australia are joining in this wave (Kawai, 2005).

## ASEAN + 3

- ASEAN+3 members have embarked on initiatives for regional financial cooperation. These initiatives are based on three major pillars:
  - (a) Creation of a regional liquidity support facility through the Chiang Mai Initiative;
  - (b) Introduction of policy dialogue and economic surveillance; and
  - (c) Development of Asian bond markets (Kawai, 2005).



## ASEAN + 6

- Japan has recently proposed broadening the “10+3” group to a “10+6” including Australia, India, and New Zealand, but the countries of the region have declared the “10+3” to be “the main vehicle,” at least for now, for pursuing their “long-term goal” of an East Asian Community.
- China’s attitude? India and Australia’s?
- (Bergsten, 2007) .

# Northeast China-Japan-Korea FTA

- First proposed by then Chinese Premier Rongji Zhu in 2002. Such studies have been mandated to **develop blueprints** for both a Northeast Asia Free Trade Area (China, Korea, and Japan). The study of a China-Japan-Korea FTA commissioned by the three governments has been carried out by:
  - — — **China:** *Development Research Center (DRC) of the State Council of China,*
  - — — **Japan:** the National Institute of Research Advancement (NIRA) of Japan,
  - — — **Korea:** Korea Institute for International Economic Policy.
- The study was to be concluded in 2007, but has been further extended to 2008.

## FTAAP: Free Trade Area of the Asia Pacific

- President George W. Bush launched the second and more comprehensive US response in late 2006 by proposing that the Asia Pacific Economic Cooperation (APEC) forum “seriously consider” the creation of a Free Trade Area of the Asia Pacific (FTAAP), which would embed the Asia-only trade initiatives in a broader framework that included the United States itself and would thereby avoid (or at least sharply limit) any new discrimination against it. The APEC leaders at Hanoi agreed to do so, and APEC is conducting studies of the issue to prepare for its further consideration at the Sydney summit in September 2007 (Bergsten 2007).

# Chiang Mai Initiatives (CMI)

- In May 2000, finance ministers of ASEAN, China, Japan and South Korea agreed to establish a regional financing arrangement called the "Chiang Mai Initiative" to swap foreign exchange reserves when necessary to fight against speculative attacks on their currencies. Under the CMI, the network of 17 bilateral currency swap arrangements among central banks totaling \$52.5 billion has been created. In May 2005, the ASEAN+3 Finance Ministers agreed to make the CMI it more effective and disciplined. This includes:
  - — — integrating the CMI with an enhanced economic surveillance process;
  - — — adopting a collective decision-making process for CMI activation as a first step toward multilateralization;
  - — — increasing the size of the existing swaps by up to 100 percent; and
  - — — doubling the size of the swaps that could be withdrawn without an IMF program from 10 percent to 20 percent.
- One of the important features of the current CMI BSAs (*Bilateral Swap Arrangements*) is that members requesting liquidity support can immediately obtain short-term financial assistance for the first 20 percent of the facility. The remaining 80 percent is provided to the requesting member under an IMF

## Regional Policy Dialogue and Economic Surveillance

- The most notable surveillance process is that of ASEAN+3 finance ministers, whose primary focus is on global, regional and national economic surveillance, macroeconomic and financial risk assessment, and policies to reduce such risks. Steps have been taken for monitoring short-term capital flows and developing a regional early-warning system to detect regional financial vulnerabilities, with a view to preventing financial crises in the future.
- The next stage will be to further strengthen the CMI and economic surveillance.
- Needed: A more permanent commitment of pooling the region's foreign exchange reserves for crisis lending and management; a centralized, professional organization that manages the CMI operation, conducts economic surveillance and prepares comprehensive policy assessments.
- Once these are done, the region may have effectively created a *de facto* Asian Monetary Fund (Kawai, 2005) .

# Asian Bond Market

- Development of well-functioning, local-currency denominated bond markets is useful in reducing incentives to rely excessively on bank financing and/or external borrowing.
- The central bank process has established Asian Bond Funds (ABF-1 and ABF-2) to stimulate the demand side, and the finance minister process has undertaken the Asian Bond Market Initiative (ABMI) to stimulate the supply side of local.
- This includes: (i) integrating the CMI with an enhanced economic surveillance process; (ii) adopting a collective decision-making process for CMI activation as a first step toward multilateralization; (iii) increasing the size of the existing swaps by up to 100 percent; and (iv) doubling the size of the swaps that could be withdrawn without an IMF program from 10 percent to 20 percent (Kawai, 2005) .

## AMF-Asian Monetary Fund

- Japan's initial proposal for an Asian Monetary Fund in 1997 elicited very sharp opposition from the United States (as well as China). The proposal was made in the midst of the financial crises of 1997–99 and was viewed by the United States as a potentially fatal disruption of the IMF, on which it was relying to counter them.

# Single Currency

- The idea of creating a single currency in Asia may appear far-fetched and unrealistic at this point. The region may begin with an exchange rate arrangement that ensures intra-regional rate stability without requiring a high degree of policy coordination (Kawai, 2005) .
- Yet to be done, at least — —
- A more credible defense mechanism against excessive currency fluctuations; a regional reserve pooling mechanism; a credible regional surveillance mechanism; consistent international regulatory and supervisory frameworks; the move toward inflation targeting by members.



## 2.2 Driving forces of EA Economic Integration

- — — ***Why International trade?***
- Two conventional wisdoms: (i). comparative advantages: technology (Ricard, 1817), endowment (Heckscher, 1919; Ohlin, 1933); (ii) New trade theory based on Economies of Scale; Linda trade pattern; Dixit and Stigilitz (1977), Krugman (1979), etc.
- (iii) Smithian-Youngian perspective: Theory of International trade based on division of labor and specialization.

# ***Why International Trade?***

## ***(iii) Smithian-Youngian perspective***

- Smith-Young Theorem (Smith, 1776; Young, 1928; Yang, 2001) – –
- Division of labor is the spring of economic growth. The division of labor is limited by extent of market (Smith, 1776), and also the extent of market is dependent on division of labor; the interactions between market expansion and division of labor result in increasing returns (Young, 1928).
- The network of division of labor expands with the increase of transaction efficiency, which is related to ***Internet, transport, communications, and trade liberalization***, and it in return expands the market size.
- The expansion of network of division of labor makes the world economy more and more integrated. The economic integration (trade, FDI, etc.) is the result of the development of the network of division of labor.

## — — ***Why Foreign Direct Investment?***

- Capital always flows to the areas with best institutions and opportunities to make profit, rather than to the areas that lack capital most. The emerging economies with enormous investment opportunities, rather than the most lagging behind economies that needs investments most, attract FDI most. Investment is not the sufficient condition for economic development (*investment fundamentalism*).
- Again, the dynamic economy and investment opportunities are the results of expansion of network of division of labor. The enlargement of roundabout production chain and the diversification of products in the process bring lots of investment opportunities.

## — — *Why Financial Cooperation?*

- With division of labor, the countries need to trade and invest each other, it then involves exchange of different currencies, and thereby arises the issue of currency stabilization. Financial cooperation is then needed.
- If there is no division of labor between the countries, then no trade is needed and there is no foreign exchange( and risk) either.
- Hence, the financial cooperation is the requirement of the expansion of network of division of labor between the East Asian economies. The more integrated the economies are, the regional financial cooperation is more needed.
- *In summary*, in the perspective of Smith and Young, trade, FDI and financial cooperation are all different aspects of the expansion of division of labor.

## 2.3 Challenges and Prospect of EA Eco Integration

- Prospect is bright, but big challenges remain.
- — — *Diversity of East Asian countries.*
- — — *How Far for East Asia to become a Community?*

## ***Diversity of East Asian countries***

- Economies of Asia are diverse and heterogeneous, in terms of :
  - — — economic systems
  - — — per capita incomes
  - — — stages of economic
  - — — institutional development
  - — — human and social conditions
  - — — political systems
  - — — cultural and religious traditions
- Without shared history of political integration under a hegemonic power (Kawai, 2005).

## How Far for East Asia to Become a Community?

- According to Zhang (2005), Wang, Yao and Zhang (2007), the condition for a real integration is: the central government must control sufficiently much revenue, and the expenditure of the lower level governments have to rely on the transfer payment. Otherwise, the central will lack sufficient authority, the local will have opportunist behaviors. EU is like structure II, not the most efficient I.

	election or nomination?	Transfer Payment?	Examples
• I.	↑	↓	US, most countries
• II	↑	↑	confederation, Early federation, EU
• III	↓	↓	Former Soviet Union
• IV	↓	↑	Fiscal federalism in China before 1993

- Three possible prospects of EU or EA: (i) American confederation during 1776-1787; (ii) early stage of US with weak federal government: Civil War and secession could not be prevented in this case. (iii) United States after WWII with strong federal government: most efficient and the strongest as a single united nation.
- If EU or EA wants to be as strong as US, it needs to make substantial changes with its fiscal arrangement to structure I.

### **3. EA Eco Integration's Impact on the Chinese Economy**

- To investigate the impact of East Asian economic integration on the Chinese economy, we need to investigate — —
- (i) The contribution of integration to China's rapid growth?
- (ii) China's problems resulting from the export-oriented growth model, related to integration.
- (iii) The solution for China's problems, and what can EA eco integration help for solving China's problems?



## ***3.1 China's Rapid Growth and Integration***

- China's rapid growth can be attributed to its reforms and openness since 1978. Through openness, China greatly benefits from (i) strong export; (ii) foreign direct investment (FDI), and (iii) new technology and managements from the outside world.
- Without openness to the rest of the world, it is impossible for China to achieve today's progress. Over the past three decades, the Chinese economy has doubled every 8 years. Its economic size in 2006 was 13.2 times its size in 1978.
- In 2007:
  - — — overtake Germany to become 2nd largest trade country: US\$ 2 trillion.
  - — — GDP close to Germany: US\$ 3.13 trillion.

# China's Economic Double Time

TABLE 1

*CHINA'S ECONOMIC DOUBLE TIME AND ITS SIZE: 1978-2033*

Year	1978	1986	1993	2001	2009 <sup>E</sup>	2017 <sup>E</sup>	2025 <sup>E</sup>	2033 <sup>E</sup>
GDP	100	210	400	823	1600	3200	6400	12800

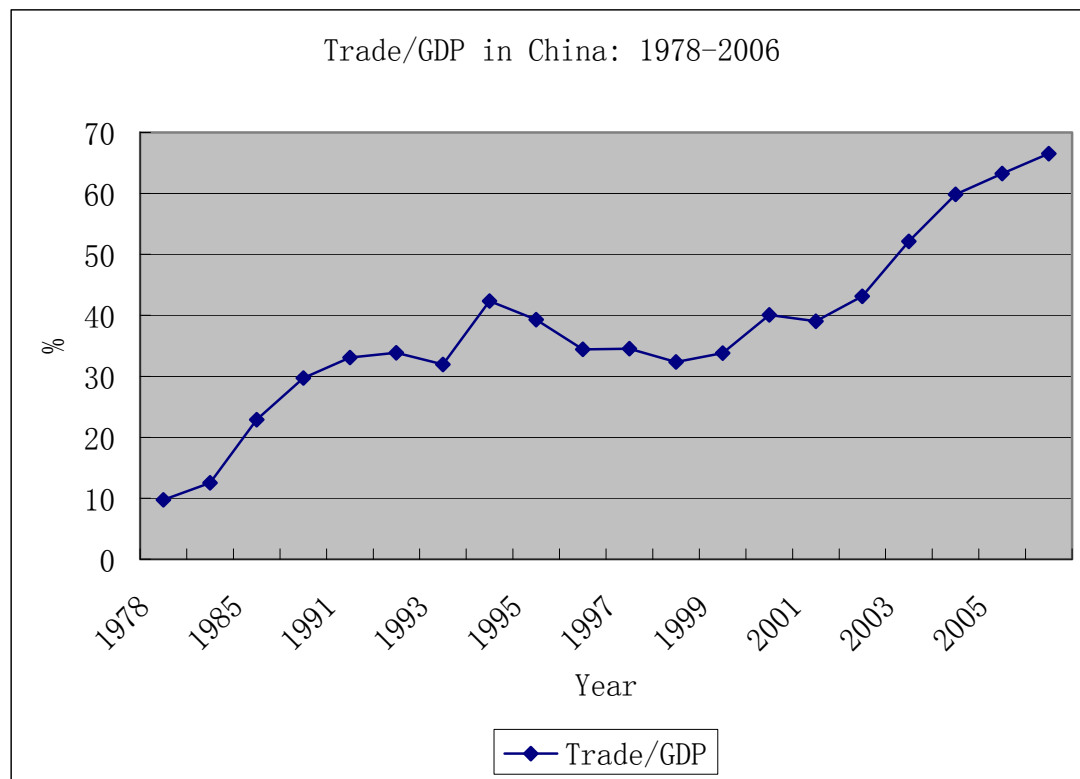
*Note:* The GDP indices in 2009, 2017, 2025 and 2033 are estimated with the assumption that Chinese economy doubles every eight years.

*Sources:* Recalculated according to data in NBS (2007)

## 3.2 *Export oriented Growth Model*

- — — **Trade/GDP in China.**
- Except the period of Asian Financial Crisis, the ratio of Trade/GDP keeps increasing in China. Most exports are FDI related.
- In 1978, the ratio was only 9.74 percent, while in 2006, this ratio increased to 66.56 percent.
- In 2005, the contribution of net export to growth rate accounted for 2.5 percentage points out of 10.4 percentage points growth rate.
- In 2006, this number was 2.3 out of 11.1.

# Figure 1 Ratio of Trade/GDP in China: 1978-2006



*Sources:* recalculated according to the data in NBS (2007).

Table 2 Share and Contribution of Net Export to GDP in China  
(1996-2006)

<i>year</i>	<i>Share of Net export in GDP (%)</i>	<i>Contribution of Net Export to GDP Growth (percentage points)</i>
1996	5.6	0.6 (10.0)
1997	44.4	4.2 (9.3)
1998	16.5	1.3 (7.8)
1999	1.6	0.1 (7.6)
2000	12.5	1.0 (8.4)
2001	-0.1	--
2002	7.6	0.7 (9.1)
2003	1.0	0.1 (10.0)
2004	6.0	0.6 (10.1)
2005	24.1	2.5 (10.4)
2006	19.5	2.2 (11.1)

*Note:* The numbers in the parentheses are GDP growth rate.

*Sources:* NBS (2007), pp. 59, 75.

## — — *Growth and Export driven by High Investment and FDI*

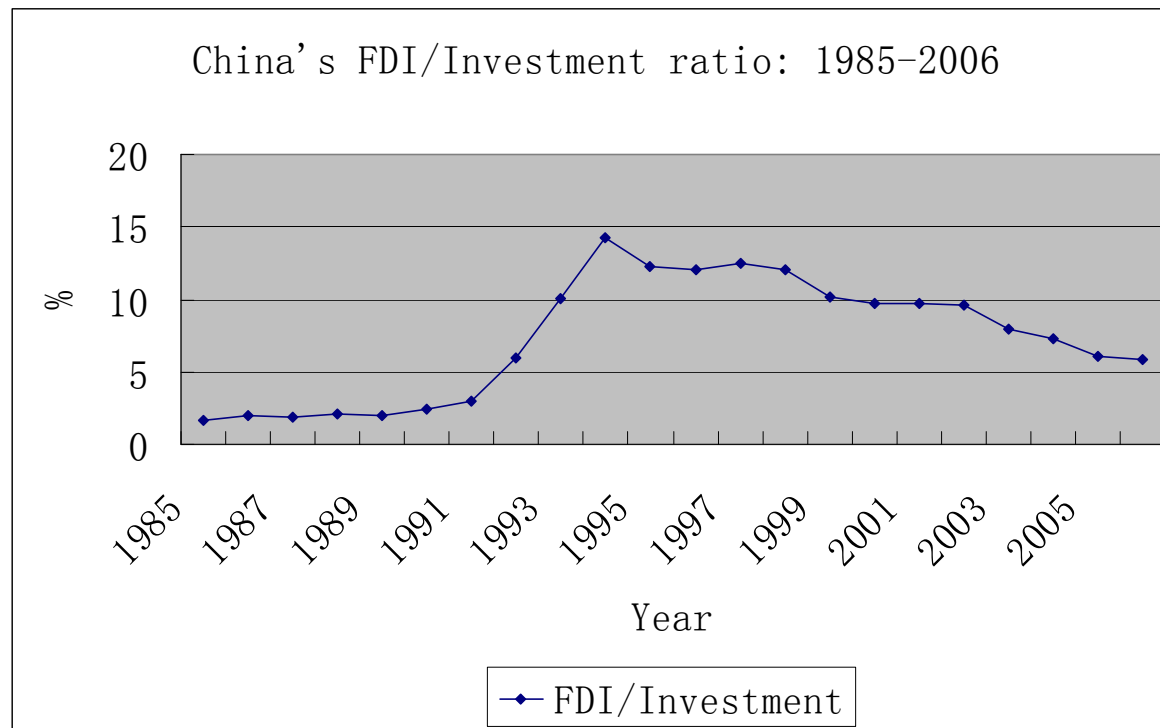
**Table 3 Share of Investment and FDI in GDP and Its Contribution to GDP Growth**

<i>year</i>	<i>Share of Investment and FDI in GDP (%) I</i>	<i>Contribution of Investment to GDP Growth (percentage points) II</i>
1996	34.3 (4.22)	0.6 (10.0)
1997	18.6 (2.32)	4.2 (9.3)
1998	26.4 (3.17)	1.3 (7.8)
1999	23.7 (2.39)	0.1 (7.6)
2000	22.4 (2.17)	1.0 (8.4)
2001	50.1 (4.91)	
2002	48.8 (4.68)	0.7 (9.1)
2003	63.7 (5.03)	0.1 (10.0)
2004	55.3 (4.04)	0.6 (10.1)
2005	37.7 (2.30)	2.5 (10.4)
2006	41.3 (2.44)	2.2 (11.1)

*Note:* The numbers in parentheses in Volume I are the share of FDI in GDP. The numbers in parentheses in Volume II are the annual GDP growth rate.

*Sources:* Recalculated according to the data in NBS (2007).

## China's FDI/Investment Ratio: 1985-2006



### ***3.3 The Biggest Problem: Will China become the next Japan in the 1990s?***

- Rapid growth rate in 2007: 11.5 %, **but**.
- — — **Tremendous trade surplus**: in 2006, the trade surplus is US\$ 177.5 billion. To Nov, 2007: US\$ 238.1 billion
- — — **Tremendous FDI**. US\$ 69.5 billion in 2006. Mid-long term FDI. Speculative investments (short for speculation, and that attracted by the prospect of RMB appreciation).
- — — **Foreign Reserves**: US\$ 1,066.3 bi in 2006. 1,433.6 bi in Sep 2007.
- — — **Excess liquidity**: the imbalance of payment will translate into excess liquidity.
- — — **Inflation**: CPI 6.9 % in Nov 2007. Goods are exported, rather than consumed by the domestic market. Domestic aggregate demand is greater than the supply. Three possible results: (a) inflation, (b) over-eating stock market, or (c) overheating house market.
- — — **Over-heating stock market**. SC index: 01/01/2006:1181; 13/12/2007: 4,959, increased by 320%. The highest: Oct 2007: 6,100, increased by 417%.
- — — **Overheating house market**. +10%, 20% 50%, 100%, or more?
- — — **Exchange rate**: against US\$ 1: 8.27 before; 21/07/2005: 1: 8.11 (+2%), 13/12/2007: 1: 7.36. appreciated by 11%. But against Euro? AU\$? Pounds?
- — — **Independence and Effectiveness of Monetary Policy?**



# Root reasons

- **China's problems are related to integration, but caused by integration. Two reasons:**
- **Domestic reasons**: governmental-led export-oriented growth model → inflexible forex regime + undervalued RMB + preferential trade and FDI policies → Trade surplus + FDI.
- **International reasons**: international monetary system: no constraints for US to issue currencies after Bretton Woods system collapsed, and an effective international monetary system yet to be established. At least, a currency, e.g. Euro, should be able to compete against US dollar.
- — — *Comparison: China's imbalance Vs. US imbalance*
- China: Trade surplus + capital account Surplus
- US: deficit based economy: Trade + capital account

### *3.4 Solution for China's economic problems*

- To adjust export-oriented policy through appreciating RMB, changing export taxation policy, foreign trade policy, etc. to achieve balance of payment:
  - — — import more
  - — — outward invest more

# Policy Dilemma on RMB

- Appreciate Fast or Slow?
- — — **Fast**: Serious Impacts on Export and Economic Growth (*think about the contribution of net export to GDP growth: 20 %*).
- — — **Slow**: the problems will get worsen! Because of the expectation to RMB appreciation: capital inflow increases, outflow slows down; more trade surplus and foreign reserves cause more appreciation pressure; monetary policy can only sticky on struggling against excess liquidity. No effectiveness on target of inflation and assets bubble.
- **Policy suggestion**: appreciate faster, but not overnight.

### *3.5 Why Is East Asian Eco Integration Good for the Solution of China's problems?*

- Though more rigorous and comprehensive evaluation yet to be made on the impact of EA Eco Integration on China's economy, the current evidences suggest that, without the integration with the rest of East Asia, China's problems would be worsen. In general, East Asian economic Integration is good for solving China's problems.
- — — Trade deficit with most of the East Asian countries.
- The trade deficit with ASEAN, Japan and Korea has reduced China's trade surplus and is good for achieving balance of payment.
- — — ASEAN is also an important outward investment destination of China.
- China is now the 8th biggest investor in ASEAN, and China's outward FDI in ASEAN grows very quickly. This trend is good to balance China's payment.
- *Most existing evaluations (CGE models) merely focus on FTAs' impacts on (or contribution to) China's future growth rate, without considering of China's sustainability of growth and the need to make major policy shift, as analyzed in this paper.*

**Table 4 China's Trade with East Asian Countries**  
(*Million US Dollars*)

<i>Countries</i>	2005			2006		
	Total	Exports	Imports	Total	Exports	Imports
ASEAN	130,359	55,365	74,994	160,838	71,311	89,527
Brunei	261	53	208	315	100	215
Cambodia	563	536	27	733	698	35
Indonesia	16,787	8,350	8,437	19,055	9,450	9,606
Laos	129	103	26	218	169	50
Malaysia	30,700	10,606	20,093	37,110	13,537	23,572
Myanmar	1,209	935	274	1,460	1,207	253
Philippines	17,557	4,688	12,870	23,413	5,738	17,675
Singapore	33,147	16,632	16,514	40,858	23,185	17,673
Thailand	21,811	7,818	13,992	27,727	9,764	17,962
VietNam	8,197	5,644	2,553	9,949	7,463	2,486
Total share in China				9.14%		
Japan	184,394	83,986	100,408	207,295	91,623	115,673
Korea	111,929	35,108	76,820	134,246	44,522	89,724

*Sources: Compiled according to the data in NBS (2007). P. 730.*

## 4. Concluding Remarks

- — — East Asian Economic Integration has achieved impressive progress. The prospect is bright, but challenges remain.
- — — Economic integration is inevitable for all countries, and will benefit all countries, but those countries with good policies and institutions will harvest more.
- — — China has greatly benefited from the global integration, including East Asian Eco Integration. Though China's current economic problems are related to integration, they are not resulted from integration, but from the government-led export-oriented growth model-related policies.
- — — China needs to make major policy shift toward balance of payment, through appreciating its currency, adjusting its export and import policies, FDI, etc.
- — — East Asian Eco Integration is good for solving China's eco problems, and China's problems can only be solved through further integration into the world economy.

- Thanks!