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The Rise of China and Regional Integration in East Asia

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Over the past decades, East Asia has achieved one of the most profound economic transformations in recorded history, and has become the most dynamic economic region and one of the most integrated areas in the world. However, regional and economic integration in East Asia is a relatively new phenomenon and cooperation is lightly institutionalized (ADB 2008b). Largely reflecting the diversity of the economies, the East Asian regionalism follows a markedly different pattern from that in Europe and other regions. In the absence of a formal institutional framework, the regional integration in East Asia has been driven by market forces and by the development of increasingly sophisticated production sharing and intra-regional network trade, in which China's rapid growth has been instrumental. It is the international firms that are creating linkages across borders in their search for profitable opportunities through trade, foreign direct investment (FDI) and other arrangements in accordance with changes in comparative advantage, industrial upgrading and unilateral liberalization of goods and capital markets in the region (Dobson, 1997; Zhang, 2003;

De Grauwe and Zhang, 2012). Policies such as preferential trading arrangements have traditionally not played much of a role in the integration of the region.

Since the early 1990s, there has been a shift from non-preferential to a preferential route to trade liberalization, and the East Asian region began moving towards more formalized preferential agreements and regionalization, with the Association of Southeast Asian Nations (ASEAN) playing a catalyst role in driving the regional integration and cooperation. The outbreak of the 1997-98 East Asian financial crisis created a greater awareness of the region's shared interests and vulnerabilities, and pushed East Asian regional cooperation and regionalism. One important lesson learnt by these economies from the financial crisis is that it is important to establish both a more resilient domestic economic and financial system and a better functioning global financial system as keys to crisis prevention, management, and resolution (Kawai, 2009). Since then a number of initiatives in the trade (the proliferation of free trade arrangements) and financial (e.g. the Chiang Mai initiative) areas have been launched as a result. It is essentially the crisis itself that led to further regional integration and cooperation in East Asia, in contrast wiht the eurozone sequence. The region's diversity, development pattern and global links have led to a unique Asian model of regionalism, i.e. a dynamic, open, multi-track, and multispeed regionalism, with an aim to build a regionally integrated and globally connected Asia to enhance prosperity not only in the region, but also in the rest of the world (ADB, 2014).

The main regional trade agreement in East Asia is the ASEAN Free Trade Area (AFTA) started in 1992. Since then and especially after the 1997-1998 financial crisis, the East Asian countries began to show a great interest in establishing FTAs, proliferating bilateral and plurilateral FTAs.[1] Nearly half of these FTAs include Japan as one of the bilateral partners, while the most prominent and comprehensive one would be the China-ASEAN Free Trade Area (CAFTA) signed off in 2002.[2] In 2007, a blueprint with action plans towards the next level of economic integration for ASEAN was adopted by the ASEAN Leaders. It aimed to transform ASEAN into a single market and fully integrated production base, and to establish the ASEAN Economic Community (AEC) by 2015.

An important milestone of the regional financial cooperation under the ASEAN+3 (China, Japan and Korea) process was the creation of the Chiang Mai Initiative (CMI) and the Asian Bond Markets Initiative (ABMI) under the Economic Review and Policy Dialogue (ERPD) in 2000. The aim of the CMI was to establish a network of bilateral swap agreements among the ASEAN+3 members to provide liquidity support to countries experiencing balance of payments difficulties and to shield

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[1] According to ADB (2014), since 2000 the number of free trade agreements (FTAs) involving at least one Asian economy has increased by an average of 15 each year, rising from 55 FTAs in 2000 to 278 as of July 2014, of which close to three-quarters are bilateral FTAs, and 75 are plurilateral (involving more than two economies). In recent years, to address the so-called "spaghetti bowl" effect of multiple regional FTAs, "mega-regional" FTAs have been pursued, including the Regional Comprehensive Economic Partnership (RCEP) involving ASEAN+6 economies, the Trans-Pacific Partnership (TPP) involving 12 Asia-Pacific nations, the Trans-Atlantic Trade and Investment Partnership involving the US and the EU, and the Japan-EU FTA under negotiation (ADB, 2014).

[2] The CAFTA aimed to establish a free trade area by 2010 between China and the six original ASEAN member states, including Brunei, Indonesia, the Philippines, Malaysia, Thailand and Singapore, and eventually to include the remaining ASEAN states of the Laos, Cambodia, Myanmar and Vietnam by 2015. With the implementation of the CAFTA in 2010, the average tariff rate on Chinese goods exported to ASEAN fell from 12.8 per cent to 0.6 per cent, while the tariff rate on ASEAN goods exported to China also fell from 9.8 per cent to 0.1 per cent. By 2015 when the free trade agreement is fully implemented, it is expected that the CAFTA will not only shape the trade relations between China and ASEAN, but also the existing regional production networks and economic integration in the region.

East Asian economies from the recurrence of currency crises. The CMI was later transformed into a single contractual, multilateral agreement, through the CMI Multilateralization (CMIM) process in 2009, with which a regional reserve pool with a size of US$120 billion under a single contract was established, with the “Plus Three” countries contributing 80 per cent and ASEAN the remaining 20 per cent. In 2011, the ASEAN+3 Macroeconomic Research Office (AMRO) was established as the CMIM regional surveillance agency to support its full operation. The ABMI aims to help develop East Asia’s local currency bond markets and deploy the region’s huge savings for regional investments, and increase the resilience of national financial systems to economic shocks. Although these initiatives have been widely viewed as important steps towards further monetary integration, it is unlikely to envisage monetary union in the near term in the absence of the institutional infrastructure in Asia (De Grauwe, 2012).

With growing economic interdependence and intensifying cooperation among East Asian countries, the region’s economic integration has evolved into a new form of international specialization, characterized by its intricate global production sharing and intra-regional network trade (see Athukorala, 2010; De Grauwe and Zhang, 2012). These networks have allowed firms to exploit comparative advantage by slicing up long production processes and allocating the production blocks throughout the East Asian region, with China being the manufacturing centre mainly for assembly by lower-skilled workers and exports of finished products throughout the world (Thorbecke and Smith, 2010). The East Asian regional production networks involve complicated combinations of intra-firm trade, arms-length transactions, and outsourcing (see Kimura and Ando, 2005). The fragmentation of production in East Asia is the major contributor to the regional economic integration through increasing intra-regional direct investment and trade, while rapid economic growth fuels regional economic interdependence and closer regional integration. Economic integration in the region is deepened with the creation of a virtuous circle of foreign direct investment (FDI), production networks and trade, through which the Chinese economy has integrated with its East Asian neighbors.

The rapid rise of China has significant implications for East Asian economic integration and the global economy. China's economic reforms, spread over three-decades, have successfully transformed the country into an important trading nation and manufacturing centre in the world. With its nearly double-digit growth rates for more than three decades from 1979 to 2014, China is now the world's second largest economy[3] and largest economy in merchandise trade and foreign exchange reserves. China's GDP amounted to US$ 9.47 trillion in 2014, accounting for about 13 per cent of the total world GDP. With an annual average growth of 8.7 percent from 2009 to 2014, China's contribution to world economic growth exceeded 30 per cent on average in this period. Despite China's recent economic slowdown, the IMF forecasts that China will continue to be the largest contributor to global GDP growth from 2014 to 2015, contributing over 24 per cent to the growth of the world economy in 2015.

China's trade/GDP ratio has gone up rapidly since its accession to WTO membership in 2001, peaked at about 70 per cent prior to the global financial crisis (GFC) in 2008. In 2009 China surpassed Germany and became the world's number one exporter, and further surpassed the US and became the world's biggest goods trading nation

[3] According to the IMF, China is ranked the world's largest economy based on purchasing power parity (PPP), with a total GDP of $17.6 trillion, just ahead of the U.S. with a GDP of $17.4 trillion in 2014.

amounting to US$4.16 trillion in 2013 and US$4.3 trillion in 2014, respectively.[4] The recent UNCTAD report shows that China was still the top destination for inward FDI in 2014, with inflows reaching US$129 billion. Meanwhile, China has transformed into a major source country of FDI in the world, and China's outward direct investment was about to catch up with its inward FDI for the first time in 2014. Nevertheless, East Asia, especially Hong Kong, is both the major contributor of FDI flows to China and the top destination for China's outward FDI, thanks to the China-centered "triangular trade" and production network in the region.

There is a widespread view that China's astonishingly rapid rise and its increasing economic prominence will reshape the international financial system and drive greater regional financial and economic integration in East Asia. The recent "New Silk Road" initiative[5] proposed by China could also foster greater inter-continental growth and cross-border trade flows and investment, and deepen regional cooperation and integration among countries both on land and at sea against a historical background of the ancient Silk Road. The implementation of this initiative is believed to offer opportunities for new complementarities and to reshape the patterns of trade, investment, infrastructure development in the region. However, the emergence of China as a regional

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[4] According to the WTO, as the world's leading merchandise exporter since 2009, China's share of world exports climbed to over 11.74 per cent in 2013 and 12.33 per cent in 2014, meanwhile its imports accounted for 10.32 per cent of the world total in 2013 and 10.26 per cent in 2014, respectively.

[5] China recently proposed the "New Silk Road" initiative composed of the Silk Road Economic Belt (the Belt) and the 21st-Century Maritime Silk Road (the Road), which are also known as "One Belt, One Road" (OBOR). The purpose of the "Belt and Road" initiative is to promote and enhance highly efficient allocation of resources and deep integration of markets, regional policy coordination, financial integration and trade liberalization across countries both on land and at sea along the Belt and Road. Partly to complement and support the Belt and Road's development, two regional institutions, Asian Infrastructure Investment Bank (AIIB) and New Silk Road Fund (NSRF), are to be established.

and global economic power has raised concerns among many over the nature and implications of China’s rise and its influence. Widespread concerns have been raised over the dynamic impact of China's rise both regionally and globally, the sustainability of China’s economic growth and the future path of regional integration in East Asia. These concerns also extend to the question of how to maintain the economic dynamism and stability in the East Asian region.

This special issue brings together a collection of articles that address these important issues concerning the rise of China and East Asian regionalism. Following the tradition of this journal, all the six articles have been double blind reviewed by two to three referees.

In his leading paper, De Grauwe analyses the experience of European monetary and financial integration and draws lessons for East Asia. One important lesson from the European experience is that financial integration inevitably follows trade integration, and that trying to fix the exchange rates when capital is freely moving is unsustainable and leads to frequent speculative crises. In this situation, the only two options available include monetary union and floating exchange rates. Monetary union requires very intrusive political unification, which does not seem possible in Asia. As a result, Asia will have to live with increasing exchange rate volatility.

How will the emergence of China and its integrated East Asian neighbours affect the world export markets? In their contribution, Abraham, Van Hove and Studnicka develop an analytical framework on heterogeneous exporting firms by incorporating competitive presence from China and Asia to examine the impact of China’s rise and Asian competition on Belgian firm-level export performance. The results show that Asian competition matters significantly for Belgian export companies both in distant markets and in their extended home base. Belgian exporters cope with foreign competition by following a variety-expansion or a quality-upgrading strategy.

In their contribution, Ho, Shi and Zhang examine the dynamic correlations and financial integration of the mainland Chinese and Hong Kong stock markets by using a regime-switching framework. They also employ a set of different DCC-GARCH-type models to account for other features including volatility persistence and asymmetry. The authors find significant evidence of volatility persistence and asymmetries in these markets. In addition, they detect that the conditional correlations between the mainland Chinese and Hong Kong stock markets are significantly time-varying and strengthening over time. The findings are consistent with our casual observation that China's economic rise and increasingly financial opening up have deepened its financial market integration with Hong Kong and the rest of the world, and will also provide a more diversified investment market for portfolio management.

China's recent slowdown has raised widespread concerns over its possible impacts on the global economy. In his contribution, Tyers employs a global macroeconomic model with national portfolio rebalancing to address these concerns and to assess the international implications of China’s “new normal” of moderate growth. The author concludes that the transition to consumption-led growth fosters employment abroad while a major Chinese recession is shown to be damaging to the advanced economies and particularly to the US, the more so if China’s policy response is expansionary and includes floating the Chinese renminbi (RMB).

The paper by Sohn investigates the effect of China’s economic rise on FDI competition in East Asia. Using a knowledge-capital model with data from the host countries of China and six ASEAN countries, and 34 FDI sourcing countries, the author finds no empirical evidence in support of the hypothesis that China's rise has "crowding FDI out" effects on its ASEAN neighbors. The paper concludes that, with deepening regional integration and supply-chain networks in East Asia, the rise of China induces a strong synergetic effect on the FDI inflows into neighboring ASEAN countries, and appears to be crowding in rather than crowding out FDI in the region.

The final paper by Sato, Shimizu, Shrestha and Zhang examines the effect of the industry-specific real exchange rate volatility on intra-Asian trade of intermediate goods at industry level using their constructed dataset of the industry-specific bilateral real exchange rates. Contrary to the recent studies, the authors find that due to the growing cross-border fragmentation and processing trade in East Asia, the real exchange rate volatility has only a weak impact on regional trade of intermediate goods along the production chain. This finding has important policy implications for the recent debate concerning the question of how possible regional exchange rate arrangements will promote further East Asia economic integration.

The collection of articles in this special issue provides important insights into the rise of China and the ongoing transformation of the East Asian region. Hopefully these contributions will stimulate further research in issues related to China's economic rise and East Asian regionalism.

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